التقرير النهائي

Final Report

تحديات الألفية ودمج البنوك الكويتية

Millennium Challenges and Merging in the Kuwaiti Banking Sector

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PREFACE

Kuwait Foundation for the Advancement of Sciences (KFAS), committed to scientific progress in the State of Kuwait, has granted support to diverse scientific projects that were directed towards technological and academic excellence. This report is an outcome of one of the projects that was sustained by KFAS.

I commend the tremendous efforts and contributions made by the peer reviewers (both local and international), sponsoring institution(s) and the project team in fulfilling and realizing the scientific mission.

It is hoped that the information furnished in this report would provide a beneficial source of reference to the scientific community as well as decision-makers.

Prof. Ali A. Al-Shamlan
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تقديـــــــم

يأتي هذا التقرير ضمن التزامات مؤسسة الكويت للتقدم العلمي بدعم المشاريع العلمية الرامية إلى التميز الأكاديمي والتكنولوجي لمساندة التقدم والتطوير في شتى المجالات الحيوية.

ولا يسعني إلا أن أثني على الجهود الخيرة التي بُذلت من قبل المؤسسات الراعية للمشاريع العلمية والكوادر العلمية المتخصصة التي أسهمت في تحقيق الأهداف العلمية لهذه المشاريع. وكذلك أود أن أتقدم بالشكر إلى المحكمين العلميين المحليين والعالميين على آرائهم القيمة التي ساعدت في اتخاذ العديد من القرارات العلمية.

نأمل أن تكون المعلومات الواردة في هذا التقرير مرجعاً للعلماء ولطلاب العلم ولمتخذي القرار.

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Abstract:

Mergers and acquisitions (M&A), especially in banking, have received worldwide attention over the past number of years because they have, in effect, changed the financial landscape of the world. There has been significant M&A activity in response to the removal of regulatory restrictions, globalization, advances in information processing and communications technologies, financial engineering and other improvements in applied finance and many other changes in market conditions. The merger wave has not only swept the world at large, it has also afflicted the MENA region and the GCC.

Reasons for consolidation differ from region to region and among economies; however, recapitalizing financial distress, increased efficiency, cost-cutting and gaining economies of scale as a result of increased size are among a few prevalent motivations of consolidation efforts in the banking sector. Bank consolidations are a direct result of fundamental economic forces, which have increased competition and improved the efficiency of our financial system. Furthermore, consolidations increase diversification of banks' portfolios, making bank collapses less likely, and hence, a healthier banking system, which is less prone to banking crises.

The banking sector in Kuwait has experienced moderate developments throughout the 1990’s. In the earlier periods, state policies had generally directed substantial resources toward sustaining existing manufacturing and trading activities, and maintaining living standards by providing explicit and implicit subsidies to enterprises and households. Since the primary role of the banking system was to channel funds to the real sector, efficiency and performance were not prioritized in this heavily supported and protected sector. However, with the inevitability of financial liberalization, embodied in the GATS, the competitiveness of this sector becomes imperative.

This study analyzes the concept and the phenomenon of mergers in the banking sector, from a global, regional and local perspective. More specifically, it focuses on the following critical dimensions of this issue: the nature of M&As in banking, the causes

and effects of merging, merging policy and regulations in various parts of the world, the banking sector in Kuwait, merging options and scenarios in the Kuwaiti banking sector and the GATS and its expected impact on mergers and consolidations within the banking sector in Kuwait.

In light of the global push to liberalize banking sectors across the world, this study has showed that competitiveness and efficiency become imperative. Although merging of banks may be economically rational and may actualize and achieve this objective, its efficacy and realization are questionable considering the political resistance that bank mergers in Kuwait would face, due to the overwhelming family ownership involved in that sector. In addition, and in line with the strive to perform competitively, Kuwait needs to integrate its financial system with the rest of the GCC countries and the world. Harmonization of the bank supervisory systems of the GCC countries towards international supervisory standards and regulations contributes immensely to the safety of the banking system and the banks' competitiveness.

Keywords: Mergers and acquisitions; efficiency; performance; competitiveness; GATS; liberalize

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الباحثين: **فاتن الجبشة، زكريا باشا**
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الملخص

استحوذت الاندماجات والاستملاكات خاصة في مجال البنوك على اهتمام عالمي خلال السنوات الماضية، لما لها من تأثيرات غيرت الساحة المالية العالمية. ويرجع النشاط الملموس لاندماج واستحواذ البنوك إلى إلغاء القيود النظامية، العولمة، تطور تقنيات الاتصال وتجهيز المعلومات، الهندسة المالية، والتحسينات الأخرى التي طرأت على التمويل التطبيقي والتغيرات الأخرى العديدة في أحوال السوق. وقد امتدت موجة الاندماج على الصعيد العالمي وشملت أيضاً إقليم الشرق الأوسط وشمال أفريقيا ومجلس التعاون الخليجي. وتختلف أسباب الاندماج من إقليم إلى إقليم وبين الاقتصاديات، ومع ذلك توجد دوافع مشتركة لجهود الاندماج في القطاع المصرفي مثل زيادة القدرة على تحمل الأزمات المالية، رفع الكفاءة، خفض التكاليف والاستفادة من مزايا اقتصاديات الحجم، إضافة إلى التأثير المباشر لقوى السوق التي عملت على تزايد المنافسة وتحسين كفاءة النظام المالي.

كما ان الاندماجات تزيد من تنوع المحافظ الاستثمارية للبنوك، وتقلل من احتمالات انهيارها وبالتالي تساعد على إيجاد بيئة مصرفية صحيحة بدرجة أكبر وقادرة على تحمل الأزمات. وقد طرأ على القطاع المصرفي الكويتي تطورات معتدلة خلال سنوات التسعينات، وفي الفترات السابقة وجهت سياسات الدولة موارد ملموسة للحفاظ على الأنشطة الصناعية والتجارية، وعلى مستويات المعيشة من خلال أشكال الدعم المختلفة، المباشرة وغير المباشرة. ولم تعط اهتمامات البنوك الكويتية أولوية للكفاءة والأداء نظراً لقوة دعم وحماية هذه البنوك واقتصار دورها الرئيسي على الوساطة بين المدخر والمستثمر، إلا إن متطلبات اتفاقيات منظمة التجارة العالمية الخاصة بتحرير القطاع المالي أثار التساؤلات والشكوك حول قدرة البنوك المحلية على المنافسة. وتحلل هذه الدراسة مفهوم وظاهرة دمج البنوك على الأصعدة العالمية والإقليمية والمحلية، وتحديداً فإنها تركز على طبيعة عمليات الدمج والاستحواذ في القطاع المصرفي، أسباب الاندماج وآثاره، قواعد وسياسات الدمج في مناطق مختلفة من العالم، حالة القطاع المصرفي الكويتي، خيارات الدمج وبدائله في القطاع المصرفي الكويتي، ولآثاره المتوقعة لاتفاقيات منظمة التجارة العالمية على الاندماجات والاستملاكات بالنسبة للقطاع المصرفي الكويتي.

أهم المصطلحات: الاندماجات والاستملاكات، فعالية، أداء، القدرة التنافسية، الاتفاقية العامة لتجارة الخدمات، تحرير

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Executive Summary

This study has analyzed the phenomenon of bank mergers from an international, regional and national perspective. The banking industry has experienced an unprecedented level of consolidation on the theoretical premise that gains can accrue through expense reduction, increased market power, reduced earnings volatility and scale and scope economies, though the actuality of acquiring these gains has not yet been verified. The 'merger movement' originated in technical progress, particularly with respect to communication technology, deregulation, general globalization and the resulting competitive challenges for financial firms, and related to the latter, monetary integration in Europe. Technological advances and regulatory revisions are often cited as central factors that have both stimulated banks and allowed more banks to merge. However, more importantly, globalization, embodied in the GATS has also pushed the merger wave, especially in developing countries in MENA and the GCC.

The study is divided into six parts, each part focusing on a specific critical dimension of mergers and acquisitions in banking. Part 1 of the study overviews mergers and acquisitions in banking, while part 2 typologizes the causes and effects of merging. Part 3 of this study presents merging policy and regulations; part 4 analyzes the banking sector in Kuwait; part 5 presents over 65 theoretical merging scenarios between banks in Kuwait and part 6 analyzes the expected impact of the GATS on the banking sector in Kuwait. In addition, this study evaluates the current status of the Kuwaiti banking sector, analyzes and evaluates financial and banking indicators of the Kuwaiti banking sector, and assesses the current competitiveness of the banking sector in Kuwait, the competitiveness of the Kuwaiti banking sector within the GCC and contemplates whether merging is an option or a necessity in the case of the Kuwaiti banking sector. The study has concluded that changes in financial markets have had a significant effect on the way banks do business and that to allow banks to compete and keep pace with these changes, the CMA (central monitoring authorities) need to develop and implement a plan for regulatory reform that is flexible and adaptable to both past and future changes in financial markets. In recent years, the CMA of GCC countries have made many regulatory changes in order to achieve certain economic and social goals. The CMA of Bahrain, Kuwait, Saudi Arabia and Oman have strengthened prudential norms in recent years.

The issue of consolidations in banking is addressed, with the perspective of expected benefits and improvements that such a strategy can bestow upon banks and the financial sector at large. However, recent research has shown that improvements in profitability are not particularly an economic consequence of mergers. It is not the act of merging that makes a union successful but rather, the dynamics of each particular merger. To be effective, merger deals need to be part of a strategic plan and the emergence of transnational banking groups will bring new risks, requiring closer cooperation between national banking supervisors. Restructuring the banking industry represents a challenge for bankers and for regulators. Banks operate in a highly competitive environment encouraged by the developments of new markets, instruments and techniques. Although many of these changes provide the means of diversifying risks, they also allow greater risks to be taken.

Mergers and acquisitions are successful when they are part of a strategy that aims to strengthen existing product lines and diversify risk. Bank mergers are driven by four main interactive forces that primarily include: regulatory reform, on-going globalization in both financial and non-financial markets, excess capacity/financial distress and technological change, including the development of electronic banking. Up to this point, bank mergers have occurred among banks based in the same national market, but there is an increasing incidence of cross-border deals in OECD countries since the remaining regulatory barriers are minimal, though political barriers with a strong foothold remain. It is important to note that numerous countries have regulations that discourage foreign takeover of domestic banks. Bank regulation is justified as necessary to correct 'market failure'. When considering bank mergers, the initial consideration is to conduct a preliminary market assessment to determine whether competition will be harmed, based on the resultant concentration ratios.

The World Trade Organization (WTO) is the only international body dealing with the rules of trade between nations. At its heart, are the WTO agreements negotiated and signed by the bulk of the world trading nations. These documents provide the legal ground rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits. The GATS covers all measures taken by members affecting trade in services and all service sectors. The agreement is unusual in taking a wide view of what constitutes trade, and defines trade in services as the supply of a service through any of four modes. Certain GATS obligations apply across-the-board, while others depend on the sector-specific

commitments assumed by individual members. The most important of the general obligations is the most-favored-nation (MFN) principle. The MFN principle prevents members from discriminating among their trading partners. While governments generally attach importance to MFN as a fundamental principle of general application, certain sectoral sensitivities that emerged in the Uruguay Round raised the specter of wholesale sectoral exclusions from the GATS as a means of avoiding the MFN rule. In order to prevent this, governments agreed to permit limited, and in principle temporary, exemptions to MFN under GATS.

Nevertheless, it is important to note that GCC banks have challenges and limitations that include their relatively small size, economies of scale, competition, modern management mechanisms and diversification of banking services. There are six commercial banks in Kuwait: National Bank of Kuwait, Gulf Bank, Al-Ahli Bank, Burgan Bank, Commercial Bank of Kuwait, and The Bank of Kuwait and the Middle East. In addition there are two specialized banks: The Industrial Bank and the Real Estate Bank. Moreover, the Credit and Saving Bank is a specialized Government bank, and Kuwait Finance House provides financial services according to Islamic principles and Shariaa. The case of Kuwait is somewhat different from the general international trend. The banking sector in Kuwait has experienced moderate developments throughout the 1990's. In the earlier periods, state policies had generally directed substantial resources toward sustaining existing manufacturing and trading activities, and maintaining living standards by providing explicit and implicit subsidies to enterprises and households. Existing conditions have almost isolated commercial banks from external competition through legal and regulatory barriers against the entry of foreign banks. Furthermore, restrictions on establishing new banks have also depressed local competition and hindered the effectiveness of market forces in adjusting the banking industry. Lately, there has been a sound call for a gradual removal of legal and regulatory barriers, as preparation for a new era of a more competitive banking market, which will be driven by the following forces:

- The implementation of WTO agreements.
- The regional (GCC) pressures on local authorities to open their financial market to other GCC based banks in order to improve competitiveness.
- The future challenges from international banks that will have access to local and regional financial markets.

- Advanced applications in computer and communications technology with the introduction of new financial instruments.
- The increasing challenges from non-banking institutions such as investment companies, some of which are beginning to attract funds management from traditional banks.
- The abolition of a government deposit guarantees system.

All of the above mentioned forces would make it necessary for local and GCC banks to urgently consider a merger strategy in order to improve their competitive edge and to enhance and build a stronger market position.

Financial markets, especially the banking sector in Kuwait was at a rudimentary stage in 1970s. A large part of domestic liquidity was in the form of cash. Today's scenario in the banking and financial sector in Kuwait is characterized by deregulation, globalisation, product innovation, high technology, better management and increased competition. Most of the Kuwaiti banks are performing modern banking services and have changed traditional banking activities. This change has created great potential for gain and has inevitably increased the risk factor. The evaluation of bank performance is a complex process involving interactions between the environment, internal operations, and external activities. Our analyses of banks' internal performance (by analysing the financial ratios of accounting items) show that most of the Kuwaiti banks performed well over the past few years. External performance is measured by evaluating the bank's market share, regulatory compliance, and public confidence. In this area of external performance Kuwaiti banks show remarkable progress. The ratings of the Kuwaiti banks indicate good credit quality and a strong capacity for timely payment of foreign currency. In terms of domestic strength, most of the banks show financially strong and sound conditions. Overall, all banks' short term outlook is either stable or positive.

The recommendations of this study are based on the premise that the pressures of liberalization are inevitable. Kuwait needs to integrate its financial system with the rest of the GCC countries. Harmonization of the bank supervisory systems of the GCC countries towards international supervisory standards and regulation has contributed immensely to the safety of the banking system and the banks' competitiveness. Central monetary authorities are very proactive in terms of supervising and monitoring the banks. The issue of bank mergers has topped the agendas of the respective Central Banks. Bank mergers are expected to be restricted to the national level at least in the short and the medium term. Monetary authorities do not encourage such interstate

mergers, preferring initial strategic decisions to be taken at the national level and later expanding across GCC borders. However, GCC banks need to be more global in their outlook and should focus on the increasing trends towards securitization of their assets. Following the trends of the international banks, GCC banks should diversify their product base into the area of corporate finance, investment management including mutual funds, mergers and acquisitions, and consulting services. Considering the existing banking conditions in Kuwait, merging between relatively small banks is needed to improve economies of scale and to be able to compete with large banks.

The study shows that out of the six commercial banks in Kuwait, the National Bank of Kuwait is relatively the largest, and dominates the local banking industry with about 40% of the market share. Therefore, when exploring the merging options between the local commercial banks according to assets size, we exclude the National Bank of Kuwait and other five banks had been our main players. Our Option results for merging between:

* Five banks is one case;
* Four banks are five cases;
* Three banks are ten cases;
* Two banks are ten cases;
* Two banks and two banks are thirty cases; and
* Three banks and two banks are ten cases.

When examining all options of the merging results between the local Kuwaiti commercial banks, after excluding the National Bank of Kuwait (NBK), our preferred choices are determined according to the following criteria:

* A market share close to that of NBK is a preferred target for any merging action in order to create more competitive banking units.
* If : M_{ij} is the market share of the i^{th} merging activity, where i = 1, 2, , n.
  S_j is the market share of the j^{th} scenario, where j = 1, 2, …, 66.

  Then: (1) M_{ij} is more preferable as it gets closer to NBK market share.

  (2) The scenario S_j is best liked if:

$$\sum_{i=1}^{n}$$

(NBK share – M_{ij}) is the least of all scenarios.

Appling the above stated conditions to our merging tables presented in the appendix, the following two scenarios (65 and 66 in the previous appendix) are generally favorable with superiority of scenario 36 since:

Scenario 66: (NBK share – M_{i65}) = (6.1 + 6.6) = 12.7 … (1)

Scenario 65: $\sum_{i=1}^{2}$ (NBK share – M_{i66}) = (4.3 +9.4) = 13.7 … (2)

Note that (1) < (2).

Therefore, according to the given criteria, scenario 66 is the best choice and scenario 65 is the second best for merging between the Kuwait commercial banks.

Kuwaiti Commercial Merging - Scenario (65)
(Amount in Million KD)

Banks	Assets	%	(NBK – M_i)
National Bank of Kuwait	4470	37.9	0.0
Merged Banks (1)	3753	31.8	4.3
Merged Banks (2)	3569	30.3	9.4
Total for All Commercial Banks	11792	100.0	13.7

(1) Al-Ahli Bank of Kuwait, Burgan Bank, BKME
(2) Gulf Bank, Commercial Bank of Kuwait

Kuwaiti Commercial Merging - Scenario (66)
(Amount in Million KD)

Banks	Assets	%	(NBK – M_i)
National Bank of Kuwait	4470	37.9	0.0
Merged Banks (1)	3957	33.6	6.1
Merged Banks (2)	3365	28.5	6.6
Total for All Commercial Banks	11792	100.0	12.7

(1) Commercial Bank of Kuwait, Burgan Bank, BKME
(2) Gulf Bank, Al-Ahli Bank of Kuwait

Between 1980 and 2000, about one sixth for all bank mergers around the world involved partners headquartered in two different countries. In the GCC region, there are 33 cross-border bank mergers, which involve foreign partners from different countries. In the case of the GCC member countries, all countries are neighbors, that share the

same language and have a common legal system. These existing conditions would increase efficiency and gains from regional banking mergers and acquisitions. Therefore, it is more likely that cross-border bank mergers within the GCC region would gradually increase in the near future.

Part 1

Review of Mergers and Acquisitions in Banking

Introduction

Mergers and acquisitions (M&A), especially in banking, have been receiving worldwide attention over the past number of years because they have in effect changed the financial landscape of the world. There has been significant M&A activity in response to the removal of regulatory restrictions, globalization, advances in information processing and communications technologies, financial engineering and other improvements in applied finance and many other changes in market conditions. There have also been many market entries of new banks, some of which are in response to the M&A activity in local banking markets.

Statistics on banking systems in various economies around the world strongly suggest the future holds even greater potential for bank consolidations. This is obvious in East Asia, Central Europe and the Americas. Reasons for consolidation differ from region to region and among economies; however, recapitalizing financial distress, increased efficiency, cost-cutting and gaining economies of scale as a result of increased size are among the few prevalent motivations of consolidation efforts in the banking sector. Table 1.1. shows the existing tendency toward a reduced number of banks and other deposit-taking institutions, evidencing the fact that the recent banking crises in Asia and Latin America have energized the pressure in favor M&A activity. Also, the banking industries in Central Europe and Latin America have been transformed, as a result of privatization of state-owned banks' which had previously dominated the banking systems of these regions. Moreover, there was an increase in M&A in the emerging economies in the 1990s, even before the 1997-98 crises, as shown in Table 1.2.

Table 1.1. Trends in Banking Systems

Region	East Asia [1]		Latin America [2]		Central Europe[3]		Advanced [4]	
Year	**1999**	**1990**	**1999**	**1990**	**1999**	**1990**	**1999**	**1990**
Number of Deposit-Taking Institutions[5]	11,761	10,100	1,741	1,344	1,154	2,087	30,361	39,766
Number of Banks	1,059	1,148	302	323	929	1,819		

[1]Sum or simple average of Korea, Malaysia, the Philippines and Thailand.
[2]Sum or simple average of Brazil, Chile, Colombia, Mexico and Peru.
[3]Sum or simple average of the Czech Republic, Hungary and Poland.
[4]Sum or simple average of Australia, euro area, Hong Kong, Japan, Singapore, Switzerland, the United Kingdom and the United States.
[5]Including commercial, savings and various types of mutual and cooperative banks, and similar Intermediaries, such as building societies, thrifts, savings and loan associations, credit unions, post banks and finance companies but *excluding* insurance companies, pension funds, unit trusts and mutual funds.

Source: Hawkins & Mihaljek, (2001)

Table 1.2. Mergers and Acquisitions in Banking

Country	Number	
	1990-96	**1997-99**
India	0	2
Hong Kong	0	0
Singapore	1	5
Indonesia	14	15
Korea	0	11
Malaysia	2	21
Philippines	14	6
Thailand	1	2
Brazil	8	38
Chile	6	6
Colombia	3	11
Mexico	5	7
Peru	5	8
Czech Republic	1	6
Hungary	3	4
Poland	124[1]	580[1]
Saudi Arabia	0	2
Europe	799	427
United States	1,607	970

[1]Mainly with cooperative banks.
Source: Hawkins & Mihaljek, (2001)

Part 1 of the study will investigate the general historical background of M&As in the banking sector. This overview will address two central issues: the economic causes of bank mergers and the international experience of M&As that have already occurred. After introducing the definitions and providing a general overview of the various types of consolidations that occur in the banking sector, the study will discuss the causes and motivations of bank mergers, review the history of bank mergers, including the provision of some landmark mergers that have occurred over the last ten years. Consecutively, the concluding section of Part 1 of this study will examine the international experience of bank consolidations in seven geographic regions in the world: North America, Latin America, Europe, the Pacific Rim, South Africa, and the Middle-East, including the Gulf Corporation Council (GCC) countries. From a geographic perspective, the remainder of the study will focus on the GCC, in particular, on the case of Kuwait and the prospects of consolidations in its banking sector.

The remaining five parts of the study will each focus on a separate aspect of mergers and consolidations in banking, in general, focusing on the GCC region and specifically, on Kuwait.

The general, the grand objectives of the study aim to examine and highlight the benefits of merging for the Kuwait banking sector, considering the variables involved to provide an operational strategy for effective mergers of Kuwait banks and to identify 'probable matches' between Kuwait commercial banks and potential GCC or international partner(s).

The second half of this study will shed light on the important issues regarding the Kuwait banking sector. Unlike its predecessors, it will aim to study and analyze the technical and financial effects of merging on the existing banks, the monetary market and the Kuwait economy. In addition, the study's main focus is to construct various scenarios of merging in an effort to provide workable options and to devise an operational, ready-to-use action plan for Kuwait banks, so that they are able to merge optimally with potential partner(s), based on certain economic and financial criteria, and encourage cooperation to develop a viable support system for post-merger integration.

The methodology that will be used to achieve these objectives will include a comparative financial analysis of Kuwait banks, which will be based on: solvency, profitability and liquidity indicators; risk assessment; capital adequacy calculations, and

market concentration indices. Quantitative and optimization techniques will be used whenever possible and appropriate.

The remainder of the study may be outlined as follows: Part 2 will explain the causes and economic effects of the process of merging on the banking sector and the economy at large, and it will explore the numerous motivations for merging, the inter-industry and intra-industry effects of merging. It will also provide an analysis of the prevalent risk factors.

Part 3 of the study will focus on merging policy and regulations. Since no mergers have taken place in Kuwait among local Kuwait banks, a discussion of the policies and regulations that will ensue if mergers take place is imperative. International and GCC M&A policies and experiences will be reviewed to establish an analytical benchmark. In addition, Kuwait's commitment to the GATS agreement and the anticipated role of the Central Bank will also be addressed. Part 3 of the study will explore the extra-regional international policy, regional policy, GCC policy, Kuwait's GATS (General Agreement on Trade in Services) commitment and liberalization, the anticipated policy in Kuwait, the anticipated role of the Central Bank of Kuwait and issues of competition and anti-trust and the logistics of merging. The culmination of the first three chapters will produce the first report of the study. Parts 4, 5 and 6 will comprise the second part of the study.

Part 4 of the study will evaluate the performance and competitiveness of the Kuwait banking sector by using the banks' indicators and comparing their results. Subsequently, the competitiveness of the Kuwait banks will be evaluated vis-à-vis Kuwait's membership in a regional trade arrangement (RTA), namely, the GCC. This part of the study will also evaluate the current status of the Kuwait banking sector, analyze and evaluate the financial and banking indicators of the Kuwait banking sector, determine the current competitiveness of the banking sector in Kuwait and the competitiveness of the Kuwait banking sector in the GCC as a Regional Trade Arrangement (RTA).

Having reviewed the concept and practice of merging from various dimensions in the previous chapters of the study, Part 5 will adopt a deterministic approach to provide various rational merging scenarios and options that may be adopted by Kuwait banks in the future, by classifying players in Kuwait's banking sector and by exploring the various merging options utilizing a deterministic approach to merging based on financial characteristics.

The final part of the study will explore the local, regional and international repercussions of the preferred merging options in the Kuwait banking sector. This part will explain and document the importance of establishing an effective support system for Kuwait banks in the post-merging phase. The details of this part of the study entail the determination of a support system that will be required in the post-merging phase and forecasting the competitiveness of the Kuwait banking sector, with prospects of enforcement of the GATS.

1. The Economic Theory of M&As

A primary objective of any research on bank M&A is to identify the motives that inevitably reflect the benefits for consolidation. Originally, the 'merger movement' gained impetus on the grounds that mergers achieve greater technical progress, (particularly in communication technology), which is imperative in the light of deregulation, general globalization and the resulting competitive challenges for financial firms, especially when they operate in economic blocs, as is the case of monetary integration in Europe. The following section will provide an overview of some of the main forces and motives that have shaped the banking industry in the emerging market economies in recent years. It proceeds by defining first the concept of consolidation, merger and acquisition activity and the differences that exist between the two strategies.

1.1. Definition of Consolidation, Merger, and Acquisition

Boyd and Graham (1991) define consolidation as a decrease in the number of firms in the industry combined, with an increase in their average size. The primary methods of consolidation employed by firms, banks or financial services institutions, are mergers and acquisitions. In both cases, two formerly independent firms become a single entity, commonly controlled and operated.

The distinction between a merger and an acquisition is somewhat vague. A merger is often defined as a transaction where one entity is combined with another so that at least one initial entity loses its distinct identity. Thus, full integration of the two firms takes place and control over a single entity can be easily exercised. An in-market merger is one that takes place between two banks operating in the same geographic area, typically a city or a metropolitan area. The merged institution often ends up with more than one branch in the same neighborhood and as a result may close overlapping offices. All mergers, whether within a market or not, result in some redundancies, and

therefore, present opportunities to save costs by eliminating certain internal systems or merging some products and services and thus, increasing efficiencies.

An acquisition is often classified as a transaction where one firm purchases a controlling stake of another firm, without combining the assets of the firms involved. Relative to acquisitions, mergers provide a greater level of control, because there is only one corporate entity to manage. Acquisitions are most appropriate when there are operational, geographic or legal reasons to maintain separate corporate structures. "*Mergers and acquisitions are methods of consolidation where a change in control takes place through a transfer of ownership*" (Group of Ten, 2001).

Both mergers and acquisitions are recorded by the date of the economic decision (formally agreed), even if the legal issues have not been fully finalized. If subsequent disputes, legal issues or a lack of supervisory approval were to interfere with the completion of a merger, it is held not to have been recorded.

1.2. Fundamental Causes of Consolidation

There are numerous causes that motivate consolidations, ranging primarily from cost saving to increasing a host of various efficiencies. Mergers and acquisitions in the financial sector are undertaken for a wide variety of reasons. The M&A phenomenon particularly among banking firms accelerated during the last ten years. Group of Ten (2001) distinguishes between motives for consolidation and the environmental/external factors that influence the form and pace of consolidation, although they are entangled in practice. Both motives and environmental factors vary over time, across countries, across industry segments and even across lines of business within a segment. The most important economic factors that have caused banking institutions to merge over the past several years include in the following:

1.2.1. Motives for Consolidation

According to Group of Ten (2001), mergers can increase expected future profits, either by reducing expected costs or by increasing expected revenues.

Cost Savings: M&As can lead to reductions in costs for a variety of reasons. The existing research literature, which focuses on cost savings attributable to economies of scale, economies of scope, or more efficient allocation of resources; however, fails to find conclusive evidence suggesting that cost savings constitute an imperative outcome

of mergers and acquisitions. Mergers can lead to reductions in costs for several reasons that include:

- Economies of scale (reductions in per-unit cost due to increased scale of operations);
- Economies of scope (reductions in per-unit cost due to synergies involved in producing multiple products within the same firm);
- Replacement of inefficient managers with more efficient managers or management techniques;
- Reduction of risk due to geographic or product diversification;
- Reduction of tax obligations;
- Increased monopoly power, allowing firms to purchase inputs at lower prices;
- Allowing a firm to become large enough to gain access to capital markets or to receive a credit rating.

Revenue Enhancement: Consolidation can lead to increased revenues through its effects on firm size, firm scope (through either product or geographic diversification), or market power. Research suggests that mergers may provide some opportunities for revenue enhancement either from efficiency gains or from increased market power. Mergers can lead to increased revenues for a variety of reasons, including:

- Increased size, allowing firms to better serve large customers;
- Increased product diversification, allowing firms to offer customers "one-stop shopping" for a variety of different products;
- Increased product or geographic diversification, expanding the pool of potential customers;
- Increased size or market share, making it easier to attract customers (visibility or reputation effects);
- Increased monopoly power, allowing firms to raise prices;
- Increased size, allowing firms to increase the diversity of their portfolios and spread risk more effectively.

1.2.2. Forces Encouraging Consolidation (Environmental/External Factors)

There are several external forces that have encouraged consolidation in the financial services industry, including the banking sector. In fact, much of the ongoing restructuring in banking industry has been a strategic response to the changes in the

competitive environment. Among the major, often interdependent forces driving change are technological innovation, deregulation, globalization, shareholder pressures, monetary integration, changes in corporate behavior and banking crises.

Technological Innovation: Banks and their customers have become increasingly adapted to the advantages of new and expensive technologies. Staying abreast of technological advancement is no longer an option in the banking sector, it is a necessity to operate in the financial sector and remain connected with other players and the market. However, these technologies are often prohibitively costly, unless costs can be spread over a large number of customers. Mergers are often necessary to allow banks to introduce and maintain the technologies that customers and the market increasingly demand.

As noted, the major issue about new IT is its impact on the processing of information, which is the very essence of the banking industry. Banks are increasingly losing their privileged access to information about investment opportunities, and are thus, under pressure to merge or to build alliances with domestic or foreign-owned banks and technology companies in order to share the costs and the development of new IT applications. The competitiveness of the banking industry relies to a large extent on its ability to adopt, utilize and maintain technological innovations. Banco Itau of Brazil offers a pertinent example, since it is building an alliance with America Online to advance its e-banking business (Hawkins and Mihaljek, 2001).

Technological progress may also have increased economies of scale in producing financial services, creating opportunities to improve efficiency and increase value through consolidation. New delivery methods for customers, such as phone centers, ATMs and on-line banking, have exhibited greater economies of scale than the traditional branching network (Berger, Demsetz and Strahan, 1999).

In addition, globalization has entailed many changes for the financial section, especially for the banks that are forced to undergo technological change and invest exorbitant resources in their information technology systems to remain competitive. The electronic revolution has undermined the traditional role of banks as intermediaries between borrowers and savers, in the process, reducing banks' profits. This, in turn, has forced banks to more urgently cut costs, and a merger with another bank becomes an attractive option to share costs, risks and acquire instant markets, links and portfolios. Online banking, in all its increasingly varied forms, has become a key channel for transacting banking business. The importance of a physical branch in a cyber-world

may decline and the nature of the services that branches provide will probably change in sight of this evolution. Table 1.3 shows that branch-based transactions are much more expensive than alternative delivery channels. More information about interaction of information technology and the current consolidation in the financial services industry can be found in (Thakor, 1999).

Table 1.3. Costs of Banking Transactions (in US dollars)

	USDS[1]	BAH[2]	GSBCG[3]
Physical branch	1.07	1.07	1.06
Phone	.52	.54	.55
ATM	.27	.27	.32
PC-based dial-up	.11	.02	.14
Internet	.01	.01	.02

[1]Estimates by US Department of Commerce, 1998.
[2]Estimates by Booz, Allen & Hamilton in 1997.
[3]Estimated by Goldman Sachs & Boston Consulting Group.

Source: Hawkins & Mihaljek, (2001).

Deregulation: Banking in emerging economies was traditionally a highly protected industry, living off spread achieved on regulated deposit and lending rates and enveloping restrictions on domestic and foreign entry. For many years, there was little pressure to disturb this restricted system. However, global markets and technology developments, macroeconomic pressures and banking crises in the 1990s have forced the banking industry and the regulators to change the old way of doing business and to deregulate the banking industry at the national level and open up financial markets to foreign competition. At the international level, the easing of restrictions on foreign entry and the search by global institutions for profit opportunities in emerging economies has led to a growing presence of foreign-owned financial institutions in domestic banking systems (Hawkins and Mihaljek, 2001).

Over the past two decades, many governments have removed important legal and regulatory barriers to financial industry consolidation. The removal of these barriers has opened the way for increased M&As, both within and across national boundaries and both within and across financial industry segments[1].

As for the US market, restrictions on banks' ability to expand geographically were relaxed in the 1980s and early 1990 with a series of removals of restriction on intra-state (within state) and inter-state (across state) banking. The removal of these

[1] Group of Ten (2001) offers a chronological listing of important regulatory changes in several countries.

constraints allowed some previously prohibited M&As to occur, which may have forced inefficient banks to become more efficient by acquiring other institutions (Berger, Demsetz and Strahan, 1999). Therefore, deregulation has given otherwise failed institutions a chance to upgrade themselves.

Globalization: Globalization is, in many respects, a by-product of technological change and deregulation. Technological advances have lowered computing costs and telecommunications, while at the same time, greatly expanding capacity, making a global reach economically more feasible. Deregulation, meanwhile, has opened up many new markets, both in developed and in transition economies (Group of Ten, 2001).

In fact, it is believed that many banks might become too small to compete effectively, either in terms of products or geography. In several countries, government and regulators are urging banks to merge not because mergers would make them better, safer or more profitable, but because it would allow them to compete internationally with main American and European banks. According to Marcus, (2000) governments and regulators should bear in mind that, very often, the best way to create local banks that can compete internationally is to allow international banks to compete locally.

Shareholder Pressures: Group of Ten (2001) shows that increased competition has helped to squeeze profit margins that has resulted in shareholder pressure to improve performance. Importantly, shareholders have gained power relative to other stakeholders in recent years. This development is expected to continue, as it is the result of a structural move towards the institutionalization of savings.

Monetary Integration in Europe: Another development that has had an impact on the competitive environment for some institutions is the creation of the Euro. The monetary and financial unit has implied increased competition among bankers and is forcing them to seek ways to cut costs and increase market share. Although the impact of the Euro on financial sector consolidations in Europe is still difficult to assess, there are reasons to believe that the Euro is stimulating consolidations on the European continent. These reasons relate primarily to the Euro-induced changes in financial markets in Europe, which provide new opportunities for realizing economies of scale and enhance revenues through consolidation (Marcus G., 2000 and Group of Ten, 2001).

Changes in Corporate Behavior: The spread of information technology has affected the banking industry through its indirect impact on corporate behavior and the

development of financial markets, especially in the area of financing new capital investment (Hawkins and Mihaljek, 2001). Many large firms can now raise funds by issuing securities more cheaply than they can borrow from banks. In fact, many large companies can borrow more cheaply in the capital markets than the banks themselves, given their better credit ratings. Therefore, banks are under increasing pressure to keep their customers, and are forced to develop techniques for improved pricing and provisioning of credit risks. Consequently, because of economies of scale in the management and diversification of credit risks, banks have an incentive to merge with other institutions, including foreign banks, which in turn leads to consolidation and a growing presence of foreign banks in the banking industry. Moreover, because of pressure from alternative funding sources and other domestic and foreign banks, there is a growing emphasis on shareholder value as the sole commercial objective of the banks.

Banking crises: There were many banking crises during the 1990s, often occurring shortly after external and banking systems were deregulated. Some of the most common sources of banking crises are microeconomic in nature, including the following: Excessive optimism about lending to rapidly expanding manufacturing firms and speculative property development; insufficiently diversified loan books; frequently inappropriate management incentives; and unappreciated risks from excessive maturity and currency mismatches. One of the most important consequences of extensive banking crises has been changes in the structure of bank ownership. Fear of bank crises and a vicious circle of credit contraction led most governments to intervene, either by nationalizing the banks in trouble and subsequently returning them to private ownership, or by encouraging bank mergers and foreign takeovers (Hawkins and Mihaljek, 2001).

1.3. The Economic Logic: How Mergers Affect Bank Performance?

Boyd and Graham (1996) present three economic arguments as to why consolidation is expected to affect the performance of the banking industry. The first argument claims is that banking is a declining industry, faced with reduced demand for the intermediation service it produces. In other words, there is excess capacity in banking, which would benefit from a mobilization of resources to other economic sectors. We reject this argument on the grounds that the data, when analyzed, does not suggest that banking is declining in any meaningful economic sense; rather, the nature

of its intermediation is just changing. Thus, there is no reason to view this as a desirable feature of consolidation, or one that would be beneficial to the banking industry.

The second argument is that consolidation will increase concentration and rent-earning in banking, thus benefiting banks, if not society. There is ample reason to believe that increasing concentration in bank markets is associated with increasing bank profitability. A large number of studies have found that, when concentration rises in bank markets, loan rates tend to rise and deposit rates tend to fall. Although this argument is surely correct, we find that the average rise in concentration in bank markets has not been enough to greatly affect profits.

The third argument is that there are economies of scale, which will be realized when banks merge; by increasing the average size of firms in the industry, consolidation may allow banks to operate more efficiently. The existing literature; however, suggests that such cost efficiencies will generally be confined to mergers involving small banks. Only small banks had the potential for economically significant scale efficiency gains and the measured inefficiencies were usually relatively small. Overall, these studies seem to support the view that economies of scale may be a motivating factor for mergers involving small or medium-sized financial services firms, particularly during the 1990s.

Moreover, almost all of the studies suggest that there were no significant scale efficiencies to be gained and possibly some slight scale efficiency losses to be suffered from M&As involving large banks (Berger, Demsetz and Strahan, 1999). Generally, they do not provide support for the view that economies of scale are an important factor driving mergers involving the very largest firms in the industry. Thus far, there seems to be little or no evidence in support of the importance of economies of scope as a motivator. The primary argument by industry practitioners for consolidation is cost reduction, enhanced operational efficiency and increased shareholder wealth (profit maximization and cost minimization). Some studies have found that mergers can potentially lower costs and increase profits in small to medium-sized banks, whereas others have shown that mergers have not resulted in any significant post-merger improvements in efficiency (Berger and Humphrey, 1992; Rhoades, 1993). De Young (1993) arrived at similar conclusions, but added the observation that the merger of two poor market performers is more likely to produce a more competitive organization than other combinations. Like many other scholars in the field, efficiency was De Young’s focal interest. As a result, much of the empirical work examining the benefits of

mergers focuses on efficiency effects. The literature in the field of banking relies on ‘efficiency’ measures to propose a position for the various financial institutions in the market. Much of the research conducted on merging is based on results of mergers in the United States, Europe and Southeast Asia. Since the merging experience is immature in the Middle East, expectations are ambiguous. Other evidence suggests that only relatively small banks could increase their efficiency due to an increase in size.

A bank’s technical efficiency may be categorized into three types: scale efficiency, scope efficiency and X-efficiency. Scale efficiency measures the bank’s operation along a cost curve. Banks operating at the minimum of the long-run average cost curve are said to be efficient; any deviation from this level of production is scale-inefficient. Scope efficiency measures the difference between the total cost of aggregated production in one bank and the sum of producing the various disaggregated outputs in more than one bank. Economies of scale in the banking industry are generally thought to be exhausted at a bank size of $100 million to $150 million in total assets (Spindt and Vefa, 1993). Large banks are defined as those that have more than $10 billion in assets and small banks are those with less than $100 million in assets. According to Peristiani (1997), the optimal scale efficiency size for a bank is approximately $800 million in assets, but Kuwait banks are relatively small, and these references may not be applicable to the local or regional economies. As greater experience is acquired, region-specific standards will be developed from accumulated research in this field.

Efficiency is a broad concept that can be applied to many dimensions of an institution’s activity. A narrow definition takes size and technology as givens, and focuses on measuring managerial efficiency, or the existing resources available to a bank, by analyzing how production factors are combined. A more holistic approach additionally incorporates economies of scale and scope, both of which vary with technologies, regulations and consumer tastes.

X-efficiency refers to the management’s level of competitiveness in operating the organization. Leibenstein (1966) introduced the theory of inefficiency generated by non-competition. Since this type of efficiency is neither allocative nor technical, Leibenstein referred to it as ‘X-efficiency’. The concept of X-efficiency leads to the existence of different cost structures associated with different market structures, higher costs being associated with non-competition. After using a stochastic cost frontier approach to estimate the technical efficiency of Kuwaiti banks, Limam (2001) found

that Kuwait banks are largely inefficient and concluded that banks need to improve their technical and X-efficiency levels to enhance their performance. For this, Limam (2001) makes the logical argument that banks operated by able managers and skilled bankers perform more competitively than banks run by poorer mangers. Limam's (2001) results also show that larger bank size, a higher share of equity capital in assets and greater profitability are associated with better efficiency.

Contrary to Limam's conclusions, however, Srinivason (1992) and Peristiani (1997) showed evidence that the most acquiring banks failed to improve their X-efficiency after the merger when compared with a control sample that did not merge, and that there was no evidence to suggest that in-market mergers lead to significant efficiency gains. However, regression analysis suggests that improvements in post-merger performance depend on the ability of the bank to strengthen asset quality (Peristiani, 1997). Peristiani (1997) also contends that X-efficiency has a positive association with ROA (return on assets) and a negative correlation with the non-interest expense ratio, indicating that X-efficient firms are, on average, more profitable and have lower operating costs relative to other banks. Additionally, X-efficient banks have less credit risk and are more likely to obtain a better bank examination rating on managerial efficiency.

Gonzalez et al. (1997) studied the financial characteristics of firms participating in cross-border mergers and acquisitions, which is an option for Kuwait, at least at the regional level. They investigated how eight financial variables affected the organization's net present value (NPV) and, hence, the probability of a successful acquisition. Results showed that the cost of debt and stock prices are the major contemporaneous causal factors of acquisition differential. (Limam, 2001).

To summarize, consolidation offer banks, and perhaps especially smaller institutions, the opportunity to achieve cost reductions and revenue enhancements. M&As can lead to reductions in costs for a variety of reasons. The existing research literature, which focuses on cost savings attributable to economies of scale, economies of scope, or a more efficient allocation of resources, fails to find much evidence suggesting that cost savings constitute an important outcome of mergers and acquisitions. Consolidation can lead to increased revenues through its effects on firm size, firm scope (through either product or geographic diversification), or market power. Research suggests that mergers may provide some opportunities for revenue enhancement, either from efficiency gains or from increased market power. Other

potential motives for consolidation include risk reduction, change in organizational focus and managerial empire building.

The most important forces encouraging consolidation are improvements in information technology, financial deregulation, globalization of financial and real markets and increased shareholder pressure for financial performance. Recent banking crises have weakened banking systems in a number of countries and banks in some countries remain on the brink of insolvency. In this environment, it is natural to consider bank mergers as a possible vehicle for improving the structure and efficiency of the banking sector. Table 1.4 summarizes a list of factors that are published by a study on financial consolidation and its potential effects (Group of Ten, 2001).

Table 1.4. List of Factors

Forces Discouraging Consolidation	**Forces Encouraging Consolidation**	**Motives for Consolidation**
Market inefficiencies	Technology : - information and communications - financial innovation - electronic commerce	Cost saving attributable to - increased size (economies of scale) - product diversification (economies of scope)
Legal and regulatory constraints	Globalization : - expansion of domestic and international capital markets - trade in non-financial products - institutionalization of savings - creation of the euro	Revenue enhancement - due to increased size (ability to serve large customers) - due to product diversification (ability to provide "one-step shopping")
Culture constraints (cross-firm and cross-segment)	Deregulation	Risk reduction due to product diversification
Deconstruction (breaking up of institutions into more specialized units	Privatization	Change in organizational focus
Outsourcing	Bailouts or financial conditions of firms	Increase market power
Internet	Climate of capital markets	Managerial empire building and retrenchment

Participated Nations: 11 G-10 Nations (United States, Canada, Japan, France, Germany, Italy, United Kingdom, Belgium, Netherlands, Sweden, Switzerland), plus Australia and Spain.

Source: (Group of Ten, 2001). A study requested by Financial Ministers and Central Bank Governors of the Group of Ten (G-10).

1.4. Theory and Literature Review of Bank Consolidation, Competition and Merger

1.4.1. Empirical Tests of Competition

In the banking literature, there are two major empirical approaches for assessing competition: (a) The structural approach and (b) The non-structural approach. The "structural approach" to model competition embraces the Structure-Conduct-Performance (SCP) paradigm and the Efficient Structure Hypothesis (ESH). The SCP paradigm, originally developed by Mason (1939) and Bain (1951), establishes a direct link from industry structure to firm conduct, and from firm conduct to industry performance; therefore, it attempt to infer the degree of competition in an industry from its structural features. The structure-conduct-performance (SCP) paradigm argues that concentration in the banking industry can generate market power, allowing banks to earn monopolistic profits by offering lower deposit rates and charging higher loan rates[2]. This view assumes that banks in a concentrated market can ignore the potential competitors due to technological and regulatory barriers to entry. The policy implication of these findings is that governments should keenly monitor bank mergers and acquisitions and strictly enforce antitrust policies.

Studies that employ the SCP approach first examine the evolution and features of the market structure, such as number and types of firms in the industry, their market shares, market concentration, barriers to entry and free competition and constraints due to regulatory or other public policy (Vesala, 1995). Then the competitive conduct of firms is typically inferred through establishing a direct link from market structure, assuming that firms behave differently in various market structures. Finally, some measures of firm and industry performance are evaluated by regressing the profit against a set of determinants of profit and some measures of concentration. Positive coefficient on the concentration measure is considered to justify the SCP paradigm, implying that concentrated markets provide the banks with the opportunities to earn monopolistic profits through their ability to offer lower deposit rates and charge higher loan rates.

The SCP paradigm is challenged by two other theoretical approaches. The first theoretical approach is the Contestable Markets Theory (CMT) developed by Baumol

[2] Proponents of this view use the frequently observed positive statistical relationship between banking market concentration and bank profitability to justify their arguments.

(1982), which stresses that a concentrated banking industry can behave competitively if the barriers for new entrants to the market are low. The Contestable Markets Theory assumes that firms can enter or rapidly leave any market without losing their capital and that potential competitors have the same cost function as incumbent firms. Baumol emphasizes the fact that incumbent firms are always vulnerable to hit-and-run entry when they try to exercise their potential market power. These features of contestable markets imply that a concentrated banking market can be effectively competitive, even if it is dominated by a handful of large banks. Therefore, policymakers should be relatively less concerned about the market dominance of some type of financial intermediaries in a country's financial system, if the financial markets are contestable. Based on these arguments, liberalization and deregulation will make the banking industry more contestable or open to competition. Therefore, the enforcement of antitrust laws by public policy makers might have a deterring effect on the performance of banks and other financial institutions.

The second challenge to the SCP paradigm comes from the "efficient structure hypothesis" (ESH) advocated by Demsetz (1973) and Peltzman (1977). ESH interprets the positive relationship between profitability and market concentration in a different way by asserting that the positive relationship is not a consequence of market power but of the greater efficiency of firms with larger market share (Demsetz, 1973). Some firm-specific factors, such as the use of latest technology or superior management, cause some firms to become profitable and grow larger, leading to market concentration. In other words, the superior performance of the market leaders endogenously determines the market structure, implying higher efficiency produces both higher concentration and greater profitability.

According to ESH, highly efficient banks (due to firm specific factors, such as technological or managerial skills, etc.) can pursue two different strategies. They can maximize their profits by maintaining the present levels of prices and firm size, or by reducing prices and expanding firm size (Lloyd-Williams et al., 1994). If the bank chooses the second option, the most efficient banks will gain market share at the expense of other relatively inefficient firms, and bank efficiency will be the leading force to market concentration. The implicit assumption is that the differing efficiencies among firms lead to unequal market shares; and hence, high levels of concentration are causally due to factors that reduce costs. The efficient structure hypothesis implies that the causal link will be between market share, a measure of a firm's efficiency and

profits, but there will be no causal relationship between market concentration and profitability (Denizer, 1997). Hence, the ESH, like the CMT, challenges the SCP paradigm by contending that the overall competitive environment faced by banks does not necessarily depend on the degree of market concentration.

"Non-structural models" suggest an alternative approach to competitive behavior. These models do not infer the competitive conduct of banks through the analysis of market structure, but rather recognize that banks behave differently, depending on the market structure in which they operate. The most central result of these models concerning competition policy is that there is no clear evidence that the use of market power would be greater in more concentrated industries. Competition may well be efficient, even in substantially concentrated industries. The non-structural model we will employ throughout our analysis is the competition model proposed by Rosse and Panzar (1977) and Panzar and Rosse (1982, 1987) or the so called “H-Statistic”.

1.4.2. The Panzar-Rosse Methodology of Bank Consolidation and Competition in Banking Merger

The Panzar-Rosse approach for testing market power relies on the premise that banks will employ different pricing strategies in response to a change in input costs, depending on the market structure in which they operate. This conjecture; therefore, implies that whether a bank operates in a competitive market, or exercises some monopoly power, that can be inferred from the analysis of that bank’s total revenue as it responds to changing input prices. Unlike the SCP paradigm, the PR methodology directly analyzes the competitive conduct of banks, based on the comparative static properties of the reduced form revenue equations, without employing any structural measures.

In order to measure the competitive structure of the industry and the market power of banks, Panzar and Rosse established a so-called "H-statistic." This is estimated as the sum of the elasticities of the reduced form (equilibrium) revenues with respect to input prices. More specifically, the H-Statistic measures the percentage change in a bank's equilibrium revenues caused by one percent change in all of the bank's input prices. Panzar and Rosse show that the H-Statistic can be used to infer competitive structure of the industry in which the bank operates by demonstrating the positive relationship between the H-Statistic and industry competitiveness. Panzar and Rosse

further show that not just the sign of the H-Statistic is important but its magnitude as well. As noted in Bikker and Haaf (2000, p.4), this approach assumes that banks are operating in their long run equilibrium; the performance of the banks is influenced by the actions of other market participants, cost structure is homogenous and the price elasticity of demand is greater than unity. By not requiring an a priori locational market definition, the Panzar-Rosse (PR) framework avoids the potential bias caused by the misspecification of market boundaries. Hence, the H-Statistic will reflect the average of the bank's conduct in each market for a bank that operates in more than one market.

The economic interpretation of the H-Statistic is as follows. If the market in which banks operate is characterized as a monopoly, then the H-Statistic is less than, or equal to, 'zero.' This is due to the economic intuition that a monopolist's revenue will respond in the opposite direction to a change in input prices, as one percent increase in input prices leads to a one percent increase in marginal costs, thus reducing equilibrium output and revenue. Panzar and Rosse further shows that the H-Statistic is also negative when the structure is a perfectly colluding oligopoly or a conjectural-variations, short-run oligopoly. The H-Statistic is equal to 'one' when the market structure is characterized as perfectly competitive in long-run equilibrium, as under this condition, a proportional shift in all input prices will increase both marginal and average costs by the same proportion, without changing the equilibrium output of banks. In order to survive the competition, banks will be forced to increase prices (e.g. interest rates on loans) until they cover the increased costs. During this adjustment process, inefficient banks might be acquired by efficient ones, or be eventually driven out of market by competition. The reduction in the number of banks in the industry will increase the demand faced by each incumbent bank, thereby leading to a rise in the output price and revenue by the same amount as costs. Shafer (1982) shows that the H-Statistic is also unity for a natural monopoly operating in a perfectly contestable market and also, for a sales-maximizing firm that is subject to breakeven constraints. If the market structure is characterized as monopolistic competition, the H-Statistic will lie between zero and unity, as revenues will increase less than proportionally to changes in input prices. Different interpretations of the Panzar-Rosse H-statistic are summarized in Table 1.5.

Table 1.5. Interpretation of H-Statistic

Estimated H	Competitive environment
$H \leq 0$	Monopoly equilibrium Perfectly colluding oligopoly Conjectural variations short-run oligopoly
$0<H<1$	Monopolistic competition free entry equilibrium.
$H=1$	Perfect competition Natural monopoly in a perfectly contestable market Sales maximizing firm subject to breakeven constraint.

Table 1.6. summarizes the previous studies that have examined the competitive structure of the banking industry in various countries by using H-statistic. Shaffer (1982) applied the PR methodology to a cross-section of banking firms in New York in 1979, and found that the competitive conduct of banks cannot be characterized as either monopolistic or perfectly competitive in the long run equilibrium. Similarly, Nathan and Neave (1989) also rejected the hypothesis of monopoly and perfect competition for Canadian banks, trust companies and mortgage companies over the period, 1982-1984. Molyneux et al. (1994) used the same analysis in a sample of German, UK, French, Italian and Spanish banks for each year of the period 1986 to 1989. On average, their results suggest a monopolistic competition in Germany, France, Spain and the UK and monopoly in Italy. Vesala (1995) applied a similar model to the Finnish banking industry and found monopolistic competition for 1985-88 and 1991-92, and perfect competition for 1989-90. Molyneux et al. (1996) examined the competitive conduct of Japanese commercial banks and found monopoly for 1986 and monopolistic competition for 1988. Coccorese (1998), Rime (1999), and Hondroyiannis et al. (1999) obtained monopolistic competition for Italian, Swiss, and Greek banking sectors. In a more recent study, De Bandt and Davis (2000) reported monopolistic competition for large banks and monopoly for small banks for Germany and France and monopolistic competition for small and large banks in Italy over the period 1992-1996. Bikker and Groeneveld (2000) found monopolistic competition of varying degrees for EU countries for the period of 1989 to 1996. Finally, in a more comprehensive study, Bikker and Haaf (2000) examined competitive conduct of banks in 23 developed countries over the time period 1988-1999. They reported that, in general, the banking markets of

industrialized countries could be characterized by monopolistic competition. They could not reject the case of monopoly for the samples of small banks in Australia and Greece and perfect competition for large banks in several countries.

Table 1.6. Summary of Literature on Bank Competition using P-R Methodology

Authors	Period	Countries Considered	Results
Nathan and Neave (1989)	1982-1984	Canada	1982:Perfect Competition 1983-1984:Monopolitic Competition
Shaffer (1982)	1979	New York	Monopolistic competition
Molyneux et al. (1994)	1986-1989	France, Germany, Italy, Spain, United Kingdom	Monopoly for Italy Monopolistic competition for France, Germany, Spain, UK
Vesala (1995)	1985-1992	Finland	Monopolistic competition for all but two years
Molyneux et al (1996)	1986-1988	Japan	1986:Monopoly 1988: Monopolistic competition
Coccorese (1998)	1988-1996	Italy	Monopolistic competition
De Bandt and Davis(1999)	1992-1996	France, Germany, Italy	Large banks: monopolistic competition in all countries; Small banks: monopolistic competition in Italy, monopoly in France and Germany
Rime (1999)	1987-1994	Switzerland	Monopolistic competition
Hondroyiannis et al. (1999)	1993-95	Greece	Monopolistic competition
Bikker and Groeneveld (2000)	1989-1996	15 EU countries	Monopolistic competition
Bikker and Haaf (2000)	1988-1998	23 Industrialized countries	Whole sample: Monopolistic competition Large banks: Monopolistic competition in general, several exceptions of perfect competition Monopoly for small banks in Australia and Greece

Source : Bikker and Haaf (2000) (updated)

1.5. Traditional Views of the Value of Mergers

Merger activity results in overall benefits to shareholders when a consolidated, post-merger firm is more valuable than a simple sum of the two separate pre-merger firms: then synergy is said to be exist. Such a merger should create value for both firms. The primary cause of this gain in value is supposed to be the performance improvement following the merger. The research on post-merger performance gains has focused on improvements in one of several areas, namely, efficiency improvements, greater market power, or greater diversification. Of efficiency gains, greater cost savings is most commonly mentioned. Many mergers have been motivated by a belief that a significant quantity of redundant operating costs could be eliminated through the consolidation of activities.

A bank is said to have economies of scale when its average cost falls as output increases. Mergers enable costs to be lowered if scale, or scope economies can be achieved. Larger institutions may be more efficient if redundant facilities and personnel are eliminated within the post-merger organization. Moreover, costs may be lowered if one bank can offer several products at a lower cost than separate banks, each providing individual products. Cost efficiency may also be improved through merger activity, especially if the management of the acquiring institution is skilled at holding down expenses for any given level of activity.

1.5.1. Underlying Theories

It has been documented that banks engage in merger because mergers may improve banking efficiency by offering a more profitable product mix, beside eliminating redundant costs and improving management. In addition, banks may also merge to take advantage of increasing market power. In either case, it is expected to be seen in an efficient capital market, a higher combined value (adjusted for the market movement) of the two merging banks upon the announcement (conditional on being unanticipated).

Various theories have been introduced to explain the wave of bank mergers. For example, the efficiency hypothesis predicts that mergers enhance efficiency and help poor banks to survive, as competition becomes increasingly intensive in the banking industry. Another well-cited hypothesis suggests that mergers increase the market

power[3] due to reduced competition. In general, studies have introduced the following three incentives for the bank mergers:

(1) Operating economics, which result from economics of scale in management, marketing and production.

(2) Financial economics, including lower transaction costs and better coverage by security analysts.

(4) Differential efficiency, which implies that the management of one firm is more efficient and that the weaker bank's assets will be more productive after the merger.

1.5.2. Literature Review

The great pace of merger activity in the banking industry has attracted a lot of interest in order to detect the wealth effects produced by such deals. The merger activity should be primarily motivated by the desire to increase shareholders' wealth. Therefore, one would expect the acquisition to generate synergies that can be achieved in several ways[4]. Particularly, a merger may exploit economics of scale, benefit from diversification in the product mix or in the geographic market extension, displace inefficient management or enhance revenues by improving marketing. Geographic or product diversification can then be valuable in stabilizing returns. This can raise value by reducing the expected value of bankruptcy costs and, accordingly, reducing the cost of capital.

There is some evidence that efficiency gains are a rational motive for acquisition. Cornet and Tehranian (1992)[5] report improvement in profitability of 30 large target banks. Financial firms can also engage in merger activity to increase their market power, thus reducing competition. If so, prices can be raised allowing the merged firm to earn monopolistic profits. Despite the fact that antitrust authorities can refuse the approval of a merger that results in a significant reduction in competition, potential gains for greater market power can still be substantial. Indeed, there is some evidence that merger deals in the banking industry are designed to increase market

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[3] On the other hand, some argue that the barriers to entry instituted by previous banking regulations may have created more market power than current market concentration.

[4] See Pilloff and Santomero (1996) and Berger, Demsetz and Strahan (1999) for analytical review of the motivations behind a merger deal.

[5] In this paper the approach of comparing pre-merger and post-merger performance using accounting data is not followed, but merger benefits are analyzed, based on the stock market reaction to merger announcements. A discussion of the two approaches as well as a survey of studies is provided by Rhoades (1994) and Pilloff and Santomero (1996).

power. For instance, intrastate mergers show higher returns than interstate mergers (Becher (2000), DeLong (1999), Houston and Ryngaert (1994)).

The pace of consolidation activity may also be determined by changes in the regulatory environment. As an illustration, the number of deals in the U.S. banking sector has increased significantly after the removal of restrictions on interstate expansion. Barriers to geographic diversification may have allowed inefficient organizations to survive. In Europe, a major impulse to consolidation activity comes from the EU directives setting the freedom of operations of financial firms across national boundaries and the implementation of the monetary union. This fosters the benefits of diversification and achievable economies of scale in cross-border mergers.

However, previous studies that examine the impact of mergers on bidders, targets and combined firms in the financial industry show mixed results. The evidence is summarized in Table 1.7. Despite their sensitivity to event window selection and to the time period, previous studies agree that targets show significantly positive returns, while abnormal returns to bidder shareholders are significantly negative, or at best, insignificantly positive. However, the combined banking firm appears to enhance value, and that is especially true in recent years.

If mergers on average fail to create value for their shareholders, it seems plausible then that a merger results from managers who tend to serve their own interests, mainly by raising their compensation as the size of the company they manage increases. Therefore, agency costs can help explain the wealth results in value enhancement. Put simply, managers may get involved in merger activity to emulate their competitors or to avoid becoming an acquisition target.

As reported in Table 1.7., we notice three important issues concerning the studies of bank mergers in the 1980s: the analysis is based on early time periods; the sample sizes are limited; and there is no analysis of combined firm returns (James and Weir,1987; Neely, 1987; Trifts and Scanlon, 1987). The empirical results of these studies are mixed for the bidder. Specifically, James and Weir (1987) and Neely (1987) show that bidder shareholders experience positive abnormal returns, while Trifts and Scanlon (1987) find that bidder shareholders experience negative abnormal returns. In addition, many of these studies have relatively small sample sizes. Trifts, and Scanlon (1987) examine 21 mergers over four years, Neely (1987) studies 26 acquisitions over 7 years, James Wier (1987) examines 60 out of 264 potential acquisitions over a 9-year

period, while Toyne and Tripp (1998) examine 68 interstate acquisitions over a 5-year period.

It is noteworthy that only a few papers examine the *overall* wealth effects of bank mergers (Becher, 2000; Houston and Ryngaert (1994)). Houston and Ryngaert find that bank merger neither creates nor destroys value for a sample of 153 mergers between 1985 and 1991. The authors show that bidders lose and targets gain experience. Also, a recent study written by Becher (2000) indicates that target and combined shareholders receive a positive wealth gain, while bidders at best break-even. His results; however, are sensitive to the event window and time period, with overall returns largest in the 1990s. More recent study for Houston et al. (2001) examine 64 large bank mergers from 1986-1996 and report, overall, that these deals create value. Their results; however, pertain to a sample of large bank merges only, and the authors do not test for cross-sectional variation in these returns.

Finally, the more recent studies of stock market reaction to bank mergers find that they do not create value for the combined firm and target shareholders gain at the expense of bidder shareholders. Houston, James, and Ryngaert (2001) and Becher (2000) also find some evidence that target shareholders may gain at the expense of bidder shareholders. However, these authors find that bank mergers in the 1990s create value for the combined firms and are not solely the result of hubristic motives. There are several alternative explanations for these inconsistencies. On the one hand, these mergers may be wealth-creating events; however, a bidder firm might overpay for the acquisition of these synergies. On the other hand, there may be identifiable differences across mergers in that certain mergers are wealth creating while others are not.

Table 1.7. Comparison of Event Studies on Bank Mergers

This table provides a summary of the results of 12 event studies on bank mergers. Authors, time period, sample, bidder return target return, and combined firm return are all taken from the original studies.

Authors	Period	Sample	Event window	Bidder return (%)	Target return (%)	Combined firm Return (%)
De Long (2001)	1988-1995	280	[-10,1]	-1.68***	16.61***	0.04
Becher David (2000)	1980-1997	553	[-30,5]	-0.1	22.64***	3.03***
Pilloff (1996)	1982-1991	48	[-20,0]	n.a.	n.a.	1.32
Houston and Ryngaert (1997)	1985-1992	184	[-2,2]	-2.40	20.40***	n.a.
Houston and Ryngaert (1994)	1985-1991	153	[-2,2]	-2.32***	14.39***	0.38
Cornett and Tehranian (1992)	1982-1987	30	[-1,0]	-0.80**	8.00***	n.a.
Cornett and De (1991)	1982-1986	152	[-1,0]	0.55***	8.10***	n.a.
Toyne and Tripp (19980	1991-1995	68	-	-2.25**	14.77***	0.46
James and Wier (1987)	1972-1983	60	[-4,0]	1.77***	n.a.	n.a.
Trifts and Scanlon (1987)	1982-1985	21	-	-3.25**	21.37*	n.a
Neely (1987)	1979-1985	26	[-10,0]	1.25	31.26***	n.a.

***, ** , and * denote significant at 1%, 5% and 10% levels, respectively.

1.6. Efficiency Effects of Bank Mergers

Over the past decade, substantial research has been devoted to the question whether bank mergers improve efficiency of the consolidating firms. The effects of bank mergers have been investigated using two basic types of methodology: event studies and comparisons of pre-merger and post-merger performance. Event studies examine the impact of merger announcement on share price. The interpretation of event studies is subject to a number of well-known problems (see Berger, 1998). It is possible

that information may have leaked to the stock market prior the merger announcement, a problem which may be especially severe during merger waves. Merger announcement may also incorporate signals unrelated to the merger. In addition, it is impossible to determine whether changes in market values are caused by changes in market power or changes in efficiency.

The examination of pre-merger and post-merger performance can take various formats. Berger, Demstez, and Strahan (1999) make a distinction between static and dynamic analyses. Static analyses are defined as studies that relate the potential consequences of merger to certain characteristics of financial institutions that are associated with merger, such as institution size. Static analyses do not use data on mergers, and hence, do not provide direct information on the effects of mergers, but they may nonetheless be useful in predicting the consequences of mergers. For example, in terms of realizable scale and scope economics. Dynamic analyses are defined as studies that compare the performance of financial institutions before and after mergers, or compare the behavior of recently consolidated banks with other banks that have not engaged in mergers. A number of studies analyze the impact of mergers with performance ratios based on accounting variables. Others investigate the evolution of the cost and profit efficiency relative to a shifting industry benchmark for merging and non-merging banks.

The literature suggests that there is a substantial potential for efficiency improvements from mergers of banks. Most recent analyses find unexploited scale economics even for fairly large bank sizes (Berger and Mester, 1997, Berger and Humphrey, 1997). The prospects for scale efficiency gains appear to be greater in the 1990s than in the 1980s. This finding is usually ascribed to technological progress, regulatory changes and the beneficial effect of lower interest rates (Berger et al., 1999). In addition, there is evidence that the banking industry exhibits substantial X-inefficiencies[6], in the order of about 20-25% of total costs (see Berger and Humphrey, 1997). This evidence suggests that mergers may substantially improve the cost efficiency when relatively efficient banks acquire relatively inefficient banks.

Some of the dynamic studies examine the extent to which the efficiency consequences of individual mergers could be predicted ex-ante. If the conditions that make a specific merger very likely to improve the ex-post efficiency can be identified,

[6] A failure by the management to maximize the profits of the bank leads to internal inefficiency, sometimes known only as inefficiency.

this may provide valuable information to policy makers in their assessment of the social value of the proposed deal. Akhavein et al. (1997) and Berger (1998) find that substantial efficiency gains were predicted if either or both of the consolidation banks were less efficient than a group of peer banks. These results are consistent with the hypothesis that the mergers have awakened entrenched mangers.

Improvement in X-efficiency is an important motive for bank mergers. Improvement in X-efficiency (movements toward the optimal point on the best-practice efficient frontier) may be accomplished through consolidation if the merger improves the managerial quality of the organization or changes its focus. X-efficiency may be improved, for example, if the bidder bank is more efficient ex ante and tends to bring the efficiency of the target up its own level by spreading its superior managerial expertise or policies and procedures over more resources. Alternatively, the merger event itself may have the effect of awakening to the need for improvement or may be used as an excuse to implement substantial unpleasant restructing.[7]

Cost X-efficiency improvements occur when a bank moves closer to what a best-practice bank's cost would be for producing the same output bundle using the same input prices and other environmental conditions. Profit X-efficiency improvements occur when a bank moves closer to the profit of a best-practice bank under the same conditions. Profit X-efficiency is a more inclusive concept than cost X-efficiency. Profit X-efficiency incorporates cost X-efficiency, the effects of scale, scope and product mix on both costs and revenues, and to some degree, the effects of changes in the risk-expected return tradeoff. Profit X-efficiency also corresponds better to the concept of value maximization than cost X-efficiency, since value is determined from both costs and revenues.

The extant research suggests a substantial potential for X-efficiency improvement for merger. Average X-inefficiencies on the order of about 20% of costs and about 50% potential profits are typical findings (Berger and Humphrey 1997). Simulation evidence also suggests that large X-efficiency gains are possible if the best-practice bidder reform the practices of inefficient targets (Savage 1991, Shaffer 1993).

The research also suggests that many banks engage in mergers for the purpose of improving X-efficiency. Many studies have found that bidder banks are more efficient ex-ante than targets (Berger and Humphery 1992, Altunbas, Maude, and Molyneux

[7] Mergers that diversify the bank may also improve X-efficiency in the long term through expanding the skill set of managers (Milbourn, Boot, and Thakor 1999).

1995, Pilloff and Santomero 1998, Rhoades 1998, Cummins and Weiss 2000). It has also been found that bidder banks bid more for targets when the merger would lead to significant diversification gains, consistent with a motive to improve the risk-expected return tradeoff and increase profit X-efficiency (Benston, Hunter and Wall 1995).

A number of studies measured the change in cost X-efficiency after mergers. Most of studies generally show very little or no cost X-efficiency improvement on average from the mergers of the 1980s, on the order of 5% of costs or less (Berger and Humphery 1992, Rhoades 1993, DeYoung 1997, Peristiani 1997). Studies using 1990s data are mixed, but sometimes showed more cost efficiency gains (Berger and Humphery 1992, Rhoades 1998, Cummins, Tennyson, and Weiss 1999).

Studies of profit X-efficiency usually paint a more favorable picture of mergers. Studies of the profit efficiency effects of mergers from the 1980s and early 1990s found that mergers improved profit efficiency and that this improvement could be linked to an increased diversification of risks and an improved risk-expected return tradeoff (Akhavein, Berger, and Humphrey 1997, Berger 1998). After merger, the banks tended to shift their asset portfolios from securities to loans, have more assets and loans per dollar of equity, and to raise additional uninsured purchased funds at reduced rates, consistent with a more diversified portfolio. Other studies using similar measures to profit X-efficiency found consistent results (Fixler and Zieschang 1993, Berger and Mester 1999, Hughes, Lang, Mester and Moon 1999).

Yet, a lot of studies conclude that the potential efficiency gains are seldom realized. A number of studies find little or no cost X-efficiency improvements on average (DeYoung, 1997; Peristiani, 1997; Berger, 1998). Apparently, the potential gains from consolidation branches, or computer operations, etc., may have been offset by managerial inefficiencies or problems in integrating systems. Case study evidence suggests that the cost efficiency effects of mergers may depend on the motivation behind the mergers and the consolidation process (Rhoades, 1998).

Parametric Cost Efficiency

The SFA is a parametric approach used in recent studies to estimate efficiency in financial institutions. SFA assumes that inefficiencies observe an asymmetric half-normal distribution, and random errors are normally distributed. Parametric (stochastic) cost efficiency is derived from a cost function in which variable costs depend on the input prices, quantities of variable outputs, random error and inefficiency. The duality

theory maintains that under certain conditions, (e.g. exogenous prices and optimal behavior of the producer), the properties of the production function, (e.g. scale and scope economies, i.e., sub-addivity), can be inferred indirectly, either by utilizing cost or profit functions. Also, it assumes that banks are cost minimizing firms; their production process can be represented by the stochastic frontier cost function:

$$\ln C = \ln C(Y, P, t, \beta) + u + v$$

where

C: represents variable cost

Y: represents the output vector

P: represents the input price vector

t : represents time and capture possible technological changes

β : represents the vector of parameters to be estimated

u: represents the one-side, non negative, stochastic element that represents cost inefficiency[8]

v: represents the classical random error term, independent from u

We need to specify a relationship (function) between bank production and bank cost in order to estimate the inefficiency. In doing this, we assume the following translog variable function:

$$\ln C_{st} = \alpha_0 + \sum_{i=1}^{3} \alpha_i \ln Y_{ist} + \sum_{i=1}^{3} \beta_i \ln P_{ist} + \frac{1}{2} \sum_{i=1}^{3} \sum_{j=1}^{3} \sigma_{ij} \ln Y_{ist} \ln Y_{ist} \ln Y_{jst} +$$

$$\frac{1}{2} \sum_{k=1}^{3} \sum_{l=1}^{3} \delta_{kl} \ln P_{kst} \ln P_{lst} + \sum_{k=1}^{3} \sum_{i=1}^{3} \mu_{ki} \ln P_{kst} \ln Y_{ist} + v_{st} + u_{st}$$

where

C_{st} = variable cost for observation s in year t

Y_{ist} = output i (i=1,2,3) for observation s in year t

P_{kst} = price of input k (k=1,2,3) for observation s in year t

v_{st} = cost inefficiency for observation s in year t

u_{st} = random error term

Cost efficiency score attains values over [0,1]. A score of 0.6 for a bank implies that it is about 60% cost efficient, i.e., it wastes about 40% of its costs relative to a bank

[8] It is assumed for the purpose of this research that u follows the half-normal distribution.

on the frontier facing similar conditions. Therefore, 1 refers to the 'best practice' while 0 refers to the 'worst practice' observed in the sample. Our main objective is to investigate the efficiency effects on bank mergers. In doing this, the above model will be estimated for the merging banks and for a relevant peer group of non-merging banks. This will allow us to detect if there is efficiency gain from merger.

Alternative (non-standard) Profit Efficiency

Alternative profit efficiency measures how close a bank is to generating maximum profits, given its output levels instead of output prices, unlike the standard profit efficiency concept. While the standard function is specified in terms of input prices and output prices, the alternative profit function is specified in terms of input prices and output quantities. In log form, alternative profit function can be written as follows:

$$\ln(\pi + a) = \ln C(Y, P, t, \beta) + u_\pi + v_\pi$$

Indeed, the alternative profit function employs the same independent variables as the cost function, as shown below:

$$\ln(\pi + a) = \alpha_0 + \sum_{i=1}^{3} \alpha_i \ln Y_{ist} + \sum_{i=1}^{3} \beta_i \ln P_{ist} + \frac{1}{2}\sum_{i=1}^{3}\sum_{j=1}^{3} \sigma_{ij} \ln Y_{ist} \ln Y_{ist} \ln Y_{jst} +$$

$$\frac{1}{2}\sum_{k=1}^{3}\sum_{l=1}^{3} \delta_{kl} \ln P_{kst} \ln P_{lst} + \sum_{k=1}^{3}\sum_{i=1}^{3} \mu_{ki} \ln P_{kst} \ln Y_{ist} + v_{st} + u_{st}$$

where, π represents net profits of the bank *b*; *a* represents a constant, which was added to every bank's profit, so that natural log is taken from a positive number since the minimum profits are typically negative, and all other variables are as explained in the previous equation. A 70% profit efficiency score for a bank suggests that it would earn about 30% more profits than what it is making now if it were operating on the efficient frontier.

2. International M&As.

The last decade has witnessed a substantial increase in the frequency and significance of bank mergers all over the world, developed and developing alike. This '*merger movement*' has been documented in detail and generally discussed in various research papers. Most of the researches conducted on merging in banking have concentrated on the US banking market, where a long history of restrictions on inter-

state banking has left a large number of banks. Merger of Western European banks have attracted more attention recently, but there are still a few studies referring to emerging economies or developing economies, and these have been mostly in Southeast Asia. Southeast Asia has experienced numerous M&A activities in its financial sector, mainly because countries like Hong Kong, Singapore and other 'tigers' are regional financial centers in their own right, whereas the merging experience in the Middle East is still immature and scarce and expectations are ambiguous.

Table 1.8 shows that fairly rapid consolidation of the banking sectors in several countries, like the Netherlands, the United Kingdom and the United States has been underway for some years, while in other countries like France, Germany, Italy, Switzerland and Japan, the pace of restructuring has occurred at a slower pace (Lumpkin S., 2000).

During the 1980's and early 1990's, the international banking industry– especially in America– underwent several mergers, for example, Bank of New York/Irving Trust, Bank of America/Security Pacific, Chemical Bank/Manufacturers Hanover Bank. Mitsui and Taiyo Kobi (Sakura) in Japan; and ABN-AMRO in Netherlands; those large mergers have also set in train a wave of more mergers in several countries in the world.

Merging activity across the world is best reviewed in a regional context. Although adopting a comparative approach may generalize many idiosyncracies and peculiarities, financial consolidation and its affiliate, globalization are phenomena that cut across national boundaries in many dimensions. The following section of this report will review and examine a number of landmark mergers that have occurred over the past ten years, in addition to an inclusion of experience of consolidations in the following six geographic regions: North America, Latin America, Europe, the Pacific Rim, South Africa and Middle-East, including Corporation Council (GCC) countries.

Table 1.8. Mergers and Acquisitions Activity in the Banking Sector

Country	Number of Transactions			
	1991-1992	1993-1994	1995-1996	1997-1998
United States	1,354	1,477	1,803	1,052
Japan	22	8	14	28
Euro Area[1]	495	350	241	203
Belgium	22	18	20	21
Finland	51	16	7	7
France	133	71	50	36
Germany	71	83	36	45
Italy	122	105	93	55
Netherlands	20	13	8	9
Spain	76	44	27	30
Norway	23	24	9	5
Sweden	38	23	8	8
Switzerland	47	59	28	22
United Kingdom	71	40	25	17
Australia	19	20	18	14
Canada	29	31	16	11
Total Banks	**2,098**	**2,032**	**2,162**	**1,360**

[1]Excluding Austria, Ireland, Luxembourg and Portugal.

Source: (Lumpkin S., 2001)

2.1. North America

The United States:

The United States banking system was historically subject to tight restrictions on geographic expansion, both within and across states. From the 1950s until the 1980s, the number of commercial banks in the United States was quite stable, ranging between 13,000 and 15,000 institutions. The first phase in the decline in the number of banking institutions occurred when the banking industry underwent turbulent experiences in the 1980s and early 1990s. Table 1.9 shows that from 1980 until 1992, the number of commercial banks declined from over 14,400 to below 11,500. Banking consolidation in this period was driven primarily by low profitability and returns in the industry, which led to industry exit.

The second phase of bank declines came with the return of the banking sector to profitability in the early 1990s, coupled with the continued need for more cost-effective

distribution networks and the entry of banks into new activities which increased the need for the formation of larger banking units. This process was further stimulated by the deregulation of restrictions on both within-state and cross-state branching, as a result of the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act (IBBEA), which eliminated many of the long-standing barriers on nationwide banking. Table 1.9 shows that from 1992 until 1997, the number of commercial banks active in the sector had fallen from 11,500 to 9200 in the USA. According to (Mishkin, 1999), nationwide banks were also beginning to emerge and with the advent of nationwide banking; the number of commercial banks was expected to fall to around 4000. With the announced merger in early 1998 between Bank of America and Nations Bank, consolidations in the banking industry were expected to eventually create a domino effect across the country.

In fact, evidence reveals the development of a rapid consolidation trend in the USA banking industry. Why is this trend occurring? Or what is driving the merger wave in USA? It seems clear that technology is the fundamental force driving the merger wave. In other words, the benefits of the technology revolution accrue most fully to very large-scale banks. The ability to share customer and product information via computer networks has greatly lowered the cost of maintaining distant branches and operating centralized call centers. The Group of Ten (2001) report shows that other factors, such as deregulation (especially cross-state banking), bailouts (particularly in the late 1980s and early 1990s) and the climate of capital markets have been determining factors. Consolidation is expected to continue in the future, with essentially the same economic factors driving deals.

Alternative perspectives on the driving forces behind the rapid consolidation trend in the US banking industry were provided by Boyd and Graham (1991), who expel the popular belief that it is mainly market forces which are causing banking consolidation; the industry is adjusting to take advantage of economies of scale, to eliminate excess capacity and to reduce the risk of bank failure. The evidence provided by Boyd and Graham (1991); however, does not generally fully support this popular belief. The popular view about economies of scale appears to be largely incorrect. After banks reach a fairly modest size, there is no cost advantage to further expansion. Some evidence even suggests diseconomies of scale for very large banks. Thus, the evidence does not support the popular belief that a quest for economies of scale is behind the banking industry's consolidation.

The conception that the banking industry is attached with excess capacity is another popular market explanation for the current consolidation trend, according to Boyd and Graham (1991). However, this relationship is far from obvious. What is clear is that the nature of banking has changed so dramatically that market-share computations, based on balance sheet data, maybe misleading. Much of the recent growth in commercial banking has been off-balance sheets, and thus, invisible in such computations.

A third popular market explanation for bank consolidation is that an increase in bank size will reduce the probability of bank failure. This explanation also fails the evidence test. The empirical evidence shows that, contrary to popular belief, larger banks have experienced downward performance trends more often than smaller banks. In fact, the data shows that since 1970, the rate of large bank failures, including banks that required government assistance, has been twice as large as small bank failures (Table 1.9).

Table 1.9. Failures Among Small and Large Banks As % of All US Banks of Each Size, 1971-1988

Asset Size of Banks	Time Period		
	1971-1979	1980-1988	1971-1988
Small (Less Than $1 Billion)	0.49	5.71	6.18
Large ($1 Billion or More)	2.19	8.00	12.55
Source: (Boyed J. and Graham S., 1991)			

Moreover, Boyd and Graham (1991) proposed government intervention as another likely candidate behind the consolidation trend rather than competitive market forces. They identified three aspects of public policy, which arguably do produce non-market incentives for consolidation, especially larger average bank size. First, the government's too-big-to-fail policy may produce an incentive for banks to increase their size. Second, government policy may be encouraging increases in bank size because of the regulatory protection from hostile takeovers that bank managers often enjoy. Third, government policy allows, or even encourages, banks in the same market to merge. However, Boyd and Graham (1991) admitted that their argument is not conclusive and that some other significant factors may have been overlooked.

Canada:

Mergers among large banks are sweeping markets around the world. Canada is no exception. The acceleration of merger activity and the resulting changes in the structure of the banks industry present important challenges to competition policy in Canada. Regulators and competition bodies in Canada maintain a tough stance on mergers. The Competition Bureau reviews proposed mergers and advises the Minister of Finance of its conclusions regarding the competitive effects of a proposed merger. Minister of Finance has the ultimate authority to approve such mergers. In January 1998, the Royal Bank of Canada and Bank of Montreal announced their intention to merge. This proposed merger would combine the first and third largest banks in Canada, ranked by the value of Canadian assets. Shortly thereafter, in April 1998, the Canadian Imperial Bank of Commerce (CIBC) and Toronto-Dominion Bank (TD Bank) announced their proposed union. This proposed merger would combine the second and fifth largest banks in Canada, ranked by the value of Canadian assets. These proposed mergers resulted in the largest merger reviews undertaken by the Bureau. Following a thorough examination, the Bureau concluded that the proposed mergers, individually and together, would result in a substantial lessening or prevention of competition in numerous product and geographic markets. Based on these and other concerns, the Minister of Finance declined to approve these transactions, and consequently, these proposed mergers were ultimately abandoned (OECD, 2000).

Table 1.9 shows that the number of commercial banks in Canada increased substantially in the 1980s before declining somewhat in the 1990s. The large rise in the earlier decade was driven by the initial entry of foreign banks, which was allowed starting in 1980. Despite increased entry by foreign banks, the leading Canadian domestic banks, of which there were five during the 1990s, tended to be very large and traditionally controlled most of the banking activity in Canada. The dominance of the largest banks increased substantially during the decade (Group of Ten, 2001).

2.2. Latin America

Latin American countries had diversified experiences with bank consolidations, where they have come mainly as a response to inefficient banking structures. In Argentina, bank consolidations have been largely driven by the domestic and external financial liberalization launched in the early 1990s, and by the progressive tightening of prudential regulations. Most mergers took place between banks having complementary

strengths in different regions. At a result, the number of banks has dropped considerably (from 180 in 1994 to 102 in 2000), but the number of branches has shrunk to a less degree.

In Brazil, bank consolidation has been driven by the privatization of state-owned banks. Once these privatizations were over, many of the 170 medium-sized banks that were still family-owned became takeover targets. In Mexico; however, consolidation has taken place in response to lack of capital availability after the 1995 banking crises. Thirteen private domestic banks that survived the crisis were recapitalized by the government through a scheme that bought their non-performing loans. Most observers believe that the Mexican banking system will go through one or more rounds of mergers among the top five banks, which control almost 80% of the total banking sector assets. Similarly, there has been a spate of mergers in Venezuela, prompted by new legislation and a banking crisis. The number of financial intermediaries fell from 167 in 1993 to 75 in 2000 and was expected to drop to 60 in 2002. It was hoped the mergers would strengthen the capital base that banks were lacking (Hawkins and Mihaljek, 2001).

2.3. Europe

European M&As surged during 1999 as the European monetary union heightened competition and forced banks to seek ways to cut costs and to increase market share. Government in many European countries welcomed the process of consolidation in banking sectors, and in some cases, even urged their banks to merge as a way of creating national champions and improving the international competitiveness of their banking sectors. The pace of M&A activity has also quickened considerably, although the overall volume of M&As has not reached the proportions registered in the United States. European banks have not faced legal restrictions on geographic expansion within national borders or on product lines, restraints that historically constrained banks in the United States. Partly reflecting this freedom, the European financial system has, in many respects, been a bank-dominated culture (Lumpkin, 2000).

The EU countries have, in the past, experienced their own specific pace and history of banking system restructuring. During the late 1980s and early 1990s a restructuring and concentration process took place in a number of smaller EU countries, such as Netherlands and Denmark, which led to the creation of large national institutions, ready to compete in this single market. In the early 1990s, in the wake of

the Scandinavian banking crisis, M&As took place to create large institutions in Sweden and Finland. Banks in the United Kingdom were not as small in international comparison, but a cycle of M&As also took place there in the late 1980s and early 1990s. In Spain, a similar process took place during the early 1990s, especially involving savings banks. Another pattern of M&As is characterized by geographic expansion into emerging markets like South-East Asia, central and eastern Europe and Latin America. EU banks, to some extent, expanded into the emerging countries with which they had historical connections- e.g. Italy, Spain and Portugal into Latin America, whereas the expansion into central and Eastern Europe was more cautious (ECB, 2000).

Table 1.10 and Table 1.11, prepared by the Banking Supervision Committee of the European System of Central Banks (ECB), investigate M&As in the EU over the past years and show the following key observations:

– 80% of total M&As were concentrated in four Member States (Germany, Italy, France, Austria) during the observation period, from 1995 to the first half of 2000 (inclusive). These four countries also have the highest number of banks among the Member States.
– The total number of M&As during the observation period, from 1995 to the first half of 2000, clearly show higher numbers of transactions in 1998 and 1999 in comparison to the three previous years. This is mainly due to the number of domestic M&As. There is information to suggest that the values involved in M&As are increasing, indicating the involvement of larger institutions.
– Over 80% of M&As occurred domestically, with 297 M&As, during the peak year, in 1999.
– According to the number of transactions, international bank M&As are more often carried out outside European Economic Area (EEA) than within it. The EEA banks seem to seek profits by expansion into emerging markets. The facts may also point in the direction that, for banking activities, the relevant market is the word more than the EEA, (e.g. asset management).
– With regard to the rationale for M&As, there is a need to differentiate according to the type of M&A, the size of the institutions involved and, in case of a cross-border operation, the target region. Small bank M&As are mostly being carried out for cost efficiency reasons (economies of scale) and to

achieve a size that allows survival. Larger bank M&As often have an element of strategic re-positioning and, like small bank M&As, are driven by considerations of economies of scale, all issues discussed earlier, and which partly form motivations for merging.

Table 1.10. Number of Total Bank M&As *(Domestic & International)*

M&As	1995	1996	1997	1998	1999	First Half 2000
Total Banks M&As	326	343	319	434	497	234
– of Which Domestic	275	293	270	383	414	172
– of Which Within EEA[1]	20	7	12	18	27	23
– of Which With Third Country	31	43	37	33	56	39

[1]EEA: European Economic Area.

Source: (ECB, 2000)

Table 1.11. Number of Domestic M&As of Credit Institutions *(Domestic & International)*

Country	1995	1996	1997	1998	1999	First Half 2000	Average
Austria	14	24	27	37	20	5	24
Belgium	6	8	7	6	6	0	7
Germany	100	117	109	189	240	91	151
Denmark	2	2	1	1	0	1	1
Spain	4	4	1	5	5	3	4
Finland	7	6	5	5	2	3	5
France	60	61	46	52	51	21	54
Greece	0	0	3	7	3	0	3
Ireland	1	1	0	2	1	0	1
Italy	68	56	45	52	64	30	57
Luxemburg	3	1	3	9	6	6	4
Netherlands	2	2	5	0	1	2	2
Portugal	5	5	1	1	0	6	2
Sweden	1	2	2	1	1	0	1
United Kingdom	2	4	15	16	14	4	10
Total	**275**	**293**	**270**	**383**	**414**	**172**	

Source: (ECB, 2000)

The 1990s saw dramatic change in the banking industries of European countries. Much of this change was driven by consolidation in its various forms. To understand these changes, it is critical that a brief overview of the European continent be provided,

represented by: Belgium, France, Germany, Italy, The Netherlands, Spain, Sweden, Switzerland, United Kingdom, Finland and Austria (Group of Ten, 2001).

Belgium:

Consolidations began influencing the banking industry around the middle of the 1990s. The total number of banks increased in the early part of the decade, before reversing course and decreasing, as evident on Table 1.9. The drop was especially pronounced after 1996 as a result of mergers and acquisitions. Mergers were initially confined to small and medium-sized banks, but several deals involved large banks towards the end of the decade. As a result of these large mergers, the number of large banks declined and concentration increased in the last few years of the decade.

France:

Significant consolidation took place among French banks in the 1990s, as revealed by the large reduction in the total number of institutions (Table 1.9). This decline was primarily driven by a decrease in the number of small banks, and because much of the consolidation activity involved small banks, concentration was largely unaffected. The French banking industry did not grow much over the decade, as assets-to-GDP remained fairly steady, although it was relatively high throughout.

Germany:

During the 1990s, the German banking industry experienced both substantial consolidation and growth. The number of banks declined one third from 4,700 to 3,200, which is was primarily a result of consolidations among savings and cooperative banks (Table 1.9). As a result, consolidation appears to have had little effect on concentration among the largest banks, while at the same time bank total assets increased relative to GDP. In addition, the ratio of deposits to assets decreased during the decade, suggesting that much of the increase in banking assets may have been due to an increase in non-depository activities conducted by German universal banks.

Italy:

Consolidation had a pronounced effect on the Italian banking industry in the 1990s. The number of banks steadily declined, falling by more than one third as shown on Table 1.12. Simultaneously, concentration increased substantially, for example, the

largest ten banks controlled almost two fifths of deposits in 1992, but that figure increased to three fifths by 1999. After growing fairly rapidly in the first few years of the decade, the banking industry actually shrank relative to GDP, possibly due to the effect of economic liberalization and privatization.

The Netherlands:

Consolidation had a large, but unique, effect on the banking industry in the Netherlands. The total number of banks did not change substantially in the 1990s, in large part due to high levels of new entry as shown on Table 1.12, whereas concentration did rise by a few percentage points. In addition, the largest banks grew substantially. Between 1990 and 1998, the aggregate assets of the three largest banks, as a percentage of GDP, more than doubled. Increased large bank presence may be due, to a large extent, to the merger of ABN and AMRO in 1991 and several significant foreign acquisitions by ING, a leading Dutch bank. The overall banking industry also grew rapidly during the decade, but not as fast as the largest banks.

Spain:

Consolidation had a relatively minor effect on the Spanish banking industry. There was a modest decline in the total number of banks in the 1990s and a small increase in the number of commercial banks, as shown on Table 1.12. Concentration figures generally remained steady between 1992 and 1997. However, more recent figures, which are not reported, are likely to be higher as a result of the mergers between Banco Santander and Banco Central Hispanoamericano (to create BSCH) and between Banco Bilbao Vizcaya and Argentaria (to create BBVA). Spanish banks exhibited modest growth rates relative to GDP in the early part of the 1990s, but no growth thereafter.

Sweden:

The banking industry in Sweden exhibited several patterns compared to other countries. First, the cooperative banks merged into one commercial bank in 1992, which accounts for the substantial decline in the number of banks in that year and is also likely to have contributed to the increased concentration in the early part of the decade, as shown on Table 1.12. Also in 1992, the largest savings banks were transformed into one banking group. It should be noted that this transaction influenced the structure of the

industry, but possibly not the reported figures, which are based on institution-level, not organization-level, data. Besides these two events, the Swedish banking industry went through further consolidation involving all the major banking groups. The result was a further decrease in the number of large institutions from six to four. At the same time, between 1992 and 1998 the number of banks increased somewhat due to foreign entry and the establishment of several new, so-called 'niche' banks that competed mainly in the household deposit market. During this time, the banking industry declined relative to GDP in the first part of the decade, before growing rapidly in the latter part.

Switzerland:

The importance of the banking industry in Switzerland is evidenced by their high level of assets, relative to GDP, as shown on Table 1.12. Moreover, asset levels grew throughout the period and, by 1997, assets were nearly five times larger than annual GDP. Four large banks accounted for most of this growth, and by 1997, they controlled assets three times larger than GDP. Increased concentration accompanied large bank growth. Concentration figures are only reported up to 1997, and therefore, do not fully reflect the increase in concentration over the decade because they omit the effects of the 1998 merger of two, very large Swiss banks: Union Bank of Switzerland and Swiss Banking Corporation. During the 1990s, the number of banks in the industry, which started at just over 450, fell by about 100, mainly due to consolidation activity that was prevalent during the 1990s. However, this decrease was not attributable to fewer commercial banks, which maintained fairly stable numbers.

United Kingdom:

There was a dramatic expansion in the number of banks competing in the United Kingdom during the 1980s from about 350 in 1980 to roughly 500 in 1990 (as shown on Table 1.12), which was primarily due to the growth of international banking and also partly due to the conversion of building societies into banks, and hence, their conversion from mutual to stock ownership. Subsequent consolidation in the 1990s; however, reduced the number of banks by almost 20%. Surprisingly, concentration ratios among the largest one of five banks in the UK banking industry fell in the 1990s, while concentration among the top ten and 15 banks rose only very modestly. In all cases, concentration fell during the late 1990s. Relative to GDP, industry assets grew at a healthy rate throughout the decade, with much of this growth arising from the expansion

of international banks operating from London. As an example of M&A, in June 1999, the Lloyds TSB Group announced that all Lloyds Bank and TSB branches were fully merged and renamed Lloyds TSB. This decision follows parliamentary approval, granted in July 1998, to merge the two banks. As a result, the Lloyds TSB Group now has the largest branch network in the UK.

Finland:

Finland has limited mergers in its banking sectors. Since the legislation on the control of concentrations entered into force in October 1998, only a few acquisitions involving banks have been concluded. On the other hand, the Finnish Competition Authority's (FCA) decisions in the financial field are made on the basis of provisions other than the merger regulations and are more likely to function as basis of the forthcoming merger assessments. The two major acquisitions that were concluded in the financial markets involved the splitting of the Savings Bank Group, which was experiencing an economic crisis, to the four biggest banks (KOP, SYP, OP Group and PSP). Prior to this, the market share of the Savings Bank Group of the banking deposits and private customer credit was approximately 25 percent. In 1995, another major bank merger took place when the two biggest commercial banks (KOP and SYP)[9] merged into Merita Bank. After the transaction, the joined market share of the parties in company funding rose to approximately 40 percent. The national authorities did not investigate the acquisition because the Finnish competition legislation had not yet included provisions on the control of concentrations. The acquisition did not fulfill the turnover thresholds of application of the EU merger regulation either. Subsequently, in 1997, Merita bank merged with the Swedish Nordbanken. The Merita/Nordbanken merger did fall within the competence of the EU competition authorities, and the European Commission accepted the acquisition. In its decision, the Commission took a stand to reduce and relieve barriers to market entry in the Finnish banking market and found that the entry of new banks into Finland was likely (OECD, 2000).

Austria:

Austria's domestic banking sector may not be the country's main source of revenue, but it is becoming more profitable, largely due to consolidation.

[9] KOP = Kansallis-Osake-Pankki; SYP = Union Bank Table of Finland.

Consolidations reached their peak in 2000 with the acquisition of Bank Austria (BA) by Germany's HypoVereinsbank (HVB). Bank Austria had itself pushed the domestic consolidation process along three years earlier with its acquisition of rival Creditanstalt (CA). Moreover, HVB’s acquisition of the new BA-CA entity should deliver more cost savings, mainly by ending duplication of Central and Eastern European and other foreign branches (Moore, 2002).

Table 1.12. Number of Banks During the Period 1980-1999

Country	Banks	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
US	All Banks	18,711	15,304	15,043	13,859	13,090	12,422	11,790	11,280	10,758	10,305	10,070
	Large Commercial Banks	100	100	100	100	100	100	100	100	100	100	100
	All Commercial Banks	14,406	12,195	11,791	11,348	10,867	10,359	9,854	9,446	9,065	8,698	8,505
Canada	All Banks	11	66	67	71	68	65	61	52	53	54	53
	Domestic Commercial Banks	11	10	11	12	12	12	12	9	11	11	11
	All Commercial Banks	11	66	67	71	68	65	61	52	53	54	53
Japan	All Banks	157	154	153	151	150	173	175	175	174	170	
	Large Commercial Banks	13	12	11	11	11	11	11	10	9	9	
	All Commercial Banks	147	144	143	141	140	140	139	136	136	130	
Australia	All Banks	16	34	31	31	33	42	42	42	42	45	44
	Large Commercial Banks	6	4	4	4	4	4	4	4	4	4	4
	All Commercial Banks											
Belgium	All Banks		115	119	121	150	147	143	140	131	119	117
	Large Commercial Banks					7	7	7	7	7	6	5
	All Commercial Banks					112	107	104	100	93	74	70
France	All Banks		1,981	1,823	1,701	1,635	1,618	1,453	1,404	1,288	1,242	
	Large Commercial Banks		5	5	5	5	5	5	5	5	5	5
	All Commercial Banks		408	414	409	415	421	413	400	398	383	
Germany	All Banks		4,719	4,460	4,200	4,038	3,872	3,784	3,674	3,577	3,403	3,167
	Large Commercial Banks		6	4	4	3	3	3	3	3	4	4
	All Commercial Banks		274	281	276	270	273	266	258	249	244	230
Italy	All Banks		379	368	351	335	284	271	264	255	248	239
	Large Commercial Banks		26	25	26	26	26	24	24	24	24	24
	All Commercial Banks											
Nether-lands	All Banks	198	180	173	177	175	173	174	172	169	162	169
	Large Commercial Banks		3	3	3	3	3	3	3	3	3	3
	All Commercial Banks											
Spain	All Banks		327	323	319	316	316	318	313	307		
	Large Commercial Banks		3	3	3	3	3	3	3	3	3	3
	All Commercial Banks		154	160	164	164	165	170	165	159		
Sweden	All Banks	598	498	450	108	109	112	116	124	124	126	
	Large Commercial Banks											
	All Commercial Banks	14	12	9	8	9	10	13	15	15	16	
Switzer-land	All Banks		457	444	434	419	393	382	370	360		
	Large Commercial Banks		4	4	4	4	4	4	4	4		
	All Commercial Banks		222	226	231	234	230	229	226	218		

2.4. Pacific Rim

Asian Countries:

In Asian countries, consolidation in the banking sector has proceeded more slowly than in the United States and Europe, as shown on Table 1.2. On the Asian Continent, mergers have generally been motivated more by the need to re-capitalize distressed financial institutions rather than a search for efficiency. Bank supervisory authorities in the region have encouraged mergers or forced acquisitions as means of salvaging failed institutions and infusing continued survival that may otherwise lead to an economy-wide catastrophe (Lumpkin, 2000). Moreover, bank mergers in this region have for the most part been government-led processes, motivated by the need to strengthen capital adequacy and the financial viability of many smaller, often family-owned banks affected by the 1997-98 crises.

Malaysia:

In 1998, the Malaysian government set up a special agency (Danamodal) to recapitalize the crisis-stricken banking industry and to strengthen and help consolidate and rationalize the entire banking system in the medium term. In spite of the Malaysian government's efforts to entice banks to merge voluntarily, offering them certain incentives, these efforts were unsuccessful. In 1999, the central bank attempted a "push" method and selected ten "anchor" banks to lead the consolidation of smaller institutions from 54 units into larger, more financially robust, viable institutions. This experience is still inconclusive in terms of its efforts on the sector and in terms of its success rate, since the mergers were only completed by the end of 2000 (Hawkins and Mihaljek, 2001).

Korea:

In Korea, recent mergers were initiated mainly by the government in order to weed out unsound banks. The government provided capital support to several private banks in 1998 through purchase and assumption operations. The assets and liabilities of five commercial and 17 merchant banks were eliminated. In 2000, the government devised a new plan to establish financial holding companies as a vehicle for additional bank mergers. Healthier banks are being induced to merger government buyouts of non-performing loans, with the prospect of increasing their market share as a way to remedy

failure in the sector. Weaker banks are expected to be aggregated under a separate holding company umbrella that would enable them to share in IT, Internet and securities ventures, as mentioned earlier, this being one of the primary motivations of mergers in the banking sector (Hawkins and Mihaljek, 2001).

Moreover, Korea provides a unique example because high barriers to foreign bank entry have been eroded by a systemic crisis of such magnitude and scope that it has required a massive capital infusion and cannot be resolved solely by consolidation of domestic institutions. As in some other episodes of systemic banking crises, the Korean banking authorities have found foreign institutions to be the only group of strategic investors with adequate financial resources, risk management skills, and managerial expertise needed to re-capitalize and restructure the failed banks. Thus, as part of a policy response to the crisis, the banking authorities have moved to strengthen governance of banks and to allow foreign investors to acquire strategic stakes in domestic institutions of up to ten per cent. Further, foreign banks, which were previously restricted to branches, were later allowed to establish branches and subsidiaries (Lumpkin, 2000).

Philippines, Thailand and Indonesia:

In the Philippines, a range of incentives is being offered to the merging banks, including better access to rediscount facilities and temporary relief from certain prudential requirements. In Thailand, the government has been involved in only one merger so far, but is supportive of private merger initiatives, especially among non-bank finance companies. Similarly, in Indonesia, four out of seven state banks existing before the crisis were consolidated into a new single state bank, Bank Mandiri, which now controls approximately 25% of total commercial bank deposits. In addition, eight private banks that had been acquired by the Indonesian Bank Restructuring Agency (IBRA) were merged during 2000 into a new institution (Danamon) (Hawkins and Mihaljek, 2001).

Hong Kong:

Contrary to the general trend, the local banking system in Hong Kong has stood somewhat distant from the general trend toward consolidations. As is the case in other tribal countries and as is the case in the Middle East, family ownership of a number of local banks is often cited as one of the reasons for this. As is often the case, evidently

family owners are usually influenced by factors, such as the desire to preserve the family heritage and to pass it on intact to the next generation. But an additional factor is that so far banks in Hong Kong have not been under economic pressure to merge because profitability has been satisfactory in absolute terms. Moreover, most banks remained profitable during the crisis itself and all continued to maintain high capital ratios.

Financial distress was; therefore, not a driving force for mergers in Hong Kong as it has been in other Asian countries. However, there are signs that the consolidation process is accelerating in Hong Kong for “classic” reasons that include increased competition from both domestic and global players, deregulation, the need to invest in new technology and the increased focus, even for family-owned businesses, on generating shareholder value.

A series of mergers that have recently taken place show that the pace of consolidations is picking up in Hong Kong. Examples of consolidations include the acquisition by Standard Chartered of the credit card and retail banking business of Chase Manhattan and the purchase by Bank of East Asia of First Pacific Bank. Moreover, Development Bank of Singapore is in the process of acquiring Dao Heng Bank, with the intention of eventually combining it with its existing locally incorporated subsidiary. Two of the Mainland banks, Bank of China and The International Commercial Bank of China (ICBC), are also consolidating their Hong Kong operations. The Bank of China move is especially significant because it will create the second largest banking group incorporated in Hong Kong, this being a major regional event with regional and possibly, extra-regional repercussions (Carse D., 2001).

Japan:

Consolidation of the Japanese banking system was mainly due to efforts to restructure a struggling industry. Similar to their regional counterparts, bank supervisory authorities in Japan have encouraged mergers or forced acquisitions as means of resolving failed institutions, and this process of consolidation is likely to continue for some time. Moreover, “Japanese banks are restructuring themselves in efforts to respond to changes in the circumstances surrounding the financial sector, such as globalization resulting from the reform of the financial system and the need to write off bad loans that had incurred because of the bursting of the speculation-driven, asset-inflating "bubble" economy.” (OECD, 2000).

In fact, M&A activity in the Japanese financial sector was rather subdued for nearly the entire 1990s, as shown on Table 1.12. Before 1999, there were few acquisitions of firms in the banking industries and a modest reduction in the number of banks at the end of the 1990s as a result of a number of bank failures. Other indicators show that Japanese banks retrenched during the 1990s. Relative to GDP, total bank assets fell modestly and large bank assets declined substantially through much of the decade. Concentration measures also tended to decline modestly. The slow growth of the 1990s provides a stark contrast to the rapid growth of the 1980s, especially among large banks. In the late 1980s and early 1990s, large Japanese banks occupied high places in the world rankings in terms of asset size. However, distress in the banking industry and lack of consolidation resulted in only one bank remaining among the top ten in 1998 (Group of Ten, 2001). Cases concerning mergers and acquisition in the financial sector include:

– The Merger between Mitsubishi Bank Co., Ltd. and the Bank of Tokyo Co., Ltd. (1995). Mitsubishi Bank Co., Ltd. and the Bank of Tokyo Co., Ltd. merged in 1995 in order to increase their international competitiveness through the expansion of their network both in Japan and abroad;
– Hokuyo Bank's acquisition of the businesses of Hokkaido Takushoku Bank (1998): Hokkaido Takushoku Bank, which was the nation's 11th largest city bank, gave up rebuilding itself because it was almost unable to raise funds from the short-term financial market. It decided instead to transfer its business in the Hokkaido area to Hokuyo Bank, which operates mainly in Hokkaido (OECD, 2000).

Recent cases of restructuring of major financial institutions include:

– Fuji Bank, Dai-Ichi Kangyo Bank Ltd. and the Industrial Bank of Japan Ltd., which have all agreed to establish a joint holding company in 2000, with total assets worth 141 trillion yen, making it the largest company in the banking sector in the world.
– Asahi Bank, Sanwa Bank and Tokai Bank have agreed to establish a joint holding company in 2001, with total assets amounting to 100 trillion yen, making it the world's second largest bank.
– Sumitomo Bank and Sakura Bank have agreed to merge into a bank in 2001 with total assets worth 99 trillion yen, making it the world's third largest bank (Group of Ten, 2001).

Australia:

Going South of the Continent, the Australian banking market is characterized by four large banks operating in all Australian States and Territories (and overseas) and a number of small regional banks typically operating in one or two States. Regulators and competition bodies in Australia maintain a strong position toward mergers. The Australian authorities maintain the “four pillar” policy in order to prevent a merger of any two or more of the big four banks. Details can be found in (OECD, 2000 and Goddard and Walker, 2001).

Financial deregulation and the opening of the banking industry to foreign competition have resulted in an increase in the number of banks in Australia over the past 15 years (Table 1.2). Despite of an increase in bank numbers, the Australian banking industry has been consistently dominated by four major banks: the Commonwealth Bank, Australia and New Zealand Banking Group (ANZ), Westpac and National Australia Bank. Concentration was initially high, but did not change much in the 1990s, although there was a drop in the middle of the decade before a modest increase towards the latter part of the 1990s (Group of Ten, 2001).

2.5. South Africa

The issue of bank mergers has only recently received adequate attention in South Africa, where the banking sector is still highly concentrated, due to the many years of economic isolation that South Africa had experienced during the 1980s. Approximately 60 banks are registered in South Africa: the largest four hold approximately 70% of total assets and the bulk of the retail banking system, while the others are mainly small specialized banks that focus on specific activities. The four dominant banks have always invested heavily in IT, and their systems are as sophisticated as those in developed countries. However, this was feasible due to their size. Moreover, South Africa has defined a clear policy for participating in globalization, and has implemented a number of economic policies that have all helped in integrating South Africa into the global financial market. However, a large proportion of the population is not served by the formal banking system and the main banks have left a vacuum in access to basic banking services in most rural areas and among the poor of the population. An informal, but largely unregulated micro-finance industry has developed. The regulator’s approach to consider whether to allow a merger to proceed can be found in (Marcus, 2001).

2.6. Middle East

The trend toward consolidation and hostile takeovers has been extensive throughout the international business community. The Middle East is also following suit in the "bigger is better" philosophy, and thus mergers are occurring, but at a much slower pace than in the rest of the world.

The Union of Arab Banks was set up by the Arab League in 1974 and comprises 300 Arab banks. On January 2000, the Union of Arab Banks warned that small Arab banks face the risk of bankruptcy, unless regional monetary authorities force them to merge and strengthen their financial position. The general secretary of the Union of Arab banks stated that, the “Arab Central Bank should mobilize, not remain lax about small banks, which are lacking in capital, supervision, administration, and technology” (Middle East Times, 2000). Efforts by central banks to force small banks to seek new shareholders, to merge or to be bought, have been lacking and lax. Incentives, such as soft loans to help finance consolidation, achieved a very small limited result. Small banks cannot compete and cope with technology and deal with the outside without capital, which should be at least doubled, adding that globalization and the Internet would let advanced foreign banks compete with much smaller Arab banks".

In the majority of the Middle East's markets, banking has traditionally carried with it a prestige that has been used to form economic rationale. In many countries, families founded banks to finance their other businesses, and gradually transformed the institution into a family jewel. Banking has generally been a profitable business, benefiting from privileged government contracts. These perks have inspired complacency. Furthermore, strict labor laws that differ between countries, in addition to divergent regulatory environments, make it much more difficult to bring in the cost-cutting benefits of cross-border consolidation than in the West.

There are presently too many small banks, and the profit potential of larger ones is constrained by the market size. In the Middle East, banks and other family run, small-scale businesses must adjust to the intensified international competition, which will arrive once states accede to the World Trade Organization. Along with these challenges, growing investment opportunities have appeared that foreign firms will capitalize upon (IPR, 1999).

Lebanon:

The Lebanese banking sector serves Lebanon, Lebanese expatriates, neighboring countries and sophisticated investors in the region, in addition to the expected long-term potential for it to serve some European and North American clientele. This will enable Lebanon to be a regional hub for financial services. In fact, the Lebanese banking sector has witnessed a substantial growth during the last few years, proving to be one of the most dynamic sectors in the economy. The Central Bank of Lebanon, being the principal regulatory body of the banking sector, has encouraged troubled banks to move towards self-liquidation, while encouraging mergers by drafting and pushing through parliament law number 192, enabling them to accomplish this objective. Moreover, the Central Bank of Lebanon introduced a number of directives and regulations to bring the sector in line with international standards. The Lebanese banking industry is marked by a high number of licenses and competition. It has experienced an unprecedented level of consolidation during the last few years. This mainly occurred on a belief that gains can accrue through expense reduction, increased market share, reduced earnings volatility and economies of scale and scope.

Over the past few years, Lebanon's banking industry has been undergoing mild consolidation, which has reduced the number of banks to 76 from 84 in 1994. Most of these have been insignificant takeovers. The Byblos-BLC (Byblos Bank of Banque Libanaise pour le Commerce) agreement is the largest merger that has occurred amongst Lebanese banks since the mid-1970, and would place Byblos in an exclusive club of leading Arab banks open to foreign investors. Experts believe that this merger will accelerate other banks' search for merger partners (IPR, 1999).

In fact, Lebanese financiers blame their industry's timid merger movement on the unwillingness of bank CEO’s (Chief Executive Officers) to cede their titles, in addition to the inflated prices demanded for mostly limited takeovers.

Jordan:

There are at present 21 commercial banks, including the Housing Bank, which is a housing-commercial bank, the Industrial Development Bank (IDB), the Cities and Villages Bank, the Cooperative Bank and the Agricultural Credit Cooperative Bank. The largest bank in Jordan and the Middle East at large is, in terms of equality and total assets, the Arab Bank. The prevailing pattern of ownership is private, which is in line with the basic philosophy of the state towards economic activity. There is a noticeable

concentration of ownership of most operating banks, while the banking sector is also characterized by both stability and conservatism. Although banks have devoted considerable efforts to the achievement of balanced geographical coverage of populated areas, branches remain concentrated in the main metropolitan centers in the country, Amman and Irbid.

The banking sector is operating under a highly deregulated environment in Jordan, whereby monetary policy relies heavily on general controls rather than on selective controls. There is also a consistent coordination between monetary and fiscal policies, on the one hand, and economic policy on the other. The banking system operates increasingly within a strategy, focused on globalization, and economic integration with other Arab countries. The Amman financial market is one of the most effective among Arab emerging markets, playing a significant role in private capital formation and privatization. However, most financial instruments are still traditional and are in the form of ordinary shares. Both the banking system and the financial market have been instrumental in attracting Arab and foreign capital investment.

Bank mergers have so far taken place in Jordan on a limited scale, and were concentrated naturally on the acquisition of small banks by larger banks, on the one hand, and weak banks by stronger banks. Bank mergers in Jordan are designed mostly to achieve many advantages that include (The Star, 1997):

– More efficient operations, because of the economies of scale in production of services, in addition to cost-saving and increased organizational effectiveness.
– An enhancement of balanced skills and cultural mix because of the combination of more than one bank in one organization.
– Wider relationships with correspondent banks abroad.
– Instant growth of bank size through mergers, compared to the alternative route; the establishment of new branches.
– Widening the market for the shares of the merged banks.
– Application of advanced, or more sophisticated, technologies, due to the increased ability to purchase cutting-edge technology.
– Stronger ability to compete in the markets, vis-à-vis other banks and financial institutions.

The Gulf Corporation Council (GCC) Countries:

Bank mergers in the GCC region have been under discussion for years without making much headway. The lack of GCC merger activity has been attributed to two key factors: the lack of incentives for banks to merge and the lack of pressure from regulatory bodies to push banks in that direction, in spite of the presence of many indicators that show that consolidation in the banking sector in these countries will produce many inter-industry and extra-industry benefits. The small size of banks in the Gulf means that even their combined assets may be inadequate to make these institutions internationally competitive; assets within one single country may be highly disparate, thereby discouraging smaller banks.

The Director General of the Arab Monetary Fund (AMF) warned of the dangers of a single bank in any one country holding more than half of the total assets of the sector. In Qatar, according to Deutsche Bank, of the 14 commercial banks, the five 100% domestically owned banks account for nearly 80% of the sector's total assets. Moreover, as long as profits are increasing, there may be very little pressure from shareholders or board members to improve efficiency, which is one of the main driving forces behind mergers, as discussed earlier. Indeed, board members may feel threatened by mergers which effectively reduce their power base and dilute their control over the bank. Divestiture of government and large family stakes in the region's bank may be a prerequisite for rationalization.

Therefore, to date most GCC mergers have been simply a process of consolidation to prevent failure rather than a strategic move to improve efficiency and enhance competitiveness. Some analysts believe that sluggish GCC bank merger activity may only be accelerated through a sustained recession in which banks will be forced to alleviate the dilution of capital value (MEES, 1998).

During the past twelve months, news of mergers between some of the world's leading corporations has made global headlines. The GCC countries, which have been relatively isolated from international economic trends, cannot remain detached for long. Consequently, the region has seen two big mergers in the past two years. In Bahrain, Gulf Internal Bank and Saudi International Bank created a single entity, and in Saudi Arabia, the 30 per cent-Citibank-owned Saudi American Bank merged with United Saudi Bank. Indeed, there should be more consolidation to create bigger banks that are competitive internationally. Cross border mergers within the Gulf region are possibly

more effective than exclusive extra-regional mergers in order to integrate the region more economically and gain geographic and market advantages for bankers.

Saudi Arabia:

One obvious consequence of market liberalization in Saudi Arabia is the occurrence of major mergers amongst Saudi banks. Across the region, over-banked domestic markets are realizing that they must consolidate their resources to survive and in some cases they are being pushed into mergers. Efforts to clear up past debt problems in Saudi Arabia have seen banks' asset quality improve; consolidation started with the 1999 merger of Saudi American Bank (SAMBA) and United Saudi Bank (USB). This merging process forms a bank with combined assets of roughly SR 80 billion ($21 billion). The announcement of the deal indicates that a new era may have dawned for Saudi banking operations. SAMBA's management team will control the assets of larger institution, which will benefit from the legacy of USB's reputation for cost control (The Banker, 2000).

Moreover, the merger of Bahrain-based Gulf International Bank (GIB) with London-based investment bank Saudi International Bank (SAIB) in April 1999, has offered further repercussions on the Saudi banking sector. GIB has disclosed plans to develop its corporate and investment banking activities in Saudi Arabia and is expected to open new branches in different areas (IPR, 1999).

The competition among external holders of stakes in local banks impedes the future merger between larger banks with partial foreign ownership. Institutions such as ABN AMRO, Citibank, HSBC and Chase Manhattan have positions in Saudi joint stock banks, which limit the potential for corporate manipulation. Yet, the prospects of some small institutions with no foreign ownership, such as Bank al-Jazira, being involved in a consolidation process may have increased following the Samba-USB merger (IPR, 1999).

Bahrain:

Strict controls on lending imposed by the Bahrain Monetary Agency (BMA), the island's central bank, are forcing banks to look at ways to expand their turnover beyond their traditional deposit business. In 1998, the BMA raised its requirement for an 8 per cent basel capital ratio to 12 per cent. The need to build its business in an increasingly constrained domestic environment was one reason why Bahrain's Al-Ahli Commercial

Bank (ACB) is merging with the London-based United Bank of Kuwait (UBK). A recent merger in Bahrain involved Faysal Islamic Bank of Bahrain (FIBB) and Islamic Investment Company of the Gulf (Bahrain), now joined under the name Shamil Bank of Bahrain, with total assets of $2.9 bn and more than $230 m equity (The Banker, 2000).

United Arab Emirates (UAE):

Banks in the UAE are relatively new and quite small; thus, any merger would be negligible in an international context. Furthermore, UAE banks are not pressured to make any changes since profits remain high and the growing need for corporate finance can be met by syndications. While economists have called for consolidation in the UAE market, which includes 20 banks, again mergers are unpopular among board members, who are disinclined to lose influence (IPR, 1999).

The Emirates International Bank (EIB) and the National Bank of Dubai (NBD) recently announced that they have been holding merger talks, which would establish the largest financial institution in the Emirates, in terms of assets. This information has also created some speculation that other UAE banks may also be formulating similar plans (Middle East Times, 1999)

According to the Managing Director of NBD (Update Magazine, 1998), UAE is definitely 'over-banked,' with 20 national banks and 27 foreign banks with 370 branches; hence, market concentration is high. He shows that “It is high time that the boards of these banks come to terms with reality and reduce the number by at least 50 per cent; about eight to nine banks are the optimum number for our requirements. We must start by merging local banks in which government has large shares. The next stage should be the merging of national banks, since we have combined interests. Finally, we must go regional. This consolidation is a global trend. We have seen multinational mergers, on a huge intercontinental scale. It is the way of the future and in order to face the challenges that are to come, we must take this initial, and perhaps difficult, step.”

Table 1.13 below summarizes merging activity that has occurred in the GCC. region. It is evident from this table that merging activity in the banking sectors of the Gulf Cooperation Council economies has been limited. In spite of the fact that there is room to improve the level of efficiency in the banking sector in GCC economies and that there have been numerous attempts to consolidate more than one banking institution, whether in a single GCC economy or within GCC borders, impediments that pervade economic logic have aborted such efforts.

Having discussed bank mergers in general through a literature review of the concept and the practice and through the experiences of various regional and extra-regional economies, we now turn to Part 2 to analyze the inter-industry and intra-industry effects of merging and the risk factors that are associated with this economic activity.

Table 1.13. Bank Acquisition and Mergers in the GCC

Date Announce	Target Name	Target Nation	Acquirer Name	Acquirer Nation
06/25/93	Oman Banking Corp	Oman	Commercial Bank of Oman	Oman
05/09/97	Oman Savings and Finance Bank	Oman	Commercial Bank of Oman	Oman
03/19/98	Bk of Oman Bahrain and Kuwait	Oman	Commercial Bank of Oman	Oman
05/29/00	Commercial Bank of Oman	Oman	Bank Muscat Al Ahli Al Omani	Oman
12/07/00	Commercial Bank of Oman	Oman	Bank Dhofar Al Omani Al Fransi	Oman
12/03/01	ABN-Amro Bahrain(ABN-Amro)	Bahrain	Bank Muscat Al Ahli Al Omani	Oman
04/14/99	Alafco (Kuwait Airways)	Kuwait	al-Aref Investment Group	Kuwait
03/15/00	National Bk of Kuwait-Lebanon	Lebanon	Al-Alhi Bank	Kuwait
05/05/99	Mannai Corp	Qatar	Ahmed Mannai & Co	Qatar
06/30/97	Saudi Cairo Bank	Saudi Arabia	United Saudi Commercial Bank	Saudi Arabia
01/06/99	United Saudi Bank	Saudi Arabia	Saudi American Bank	Saudi Arabia
12/09/91	Middle East Bank	Utd Arab Em	Emirates Bank International	Utd Arab Em
08/01/00	Union Properties Ltd	Utd Arab Em	Emirates Bank International	Utd Arab Em
03/19/85	Sun Hung Kai Bank Ltd	Hong Kong	Arab Banking Corp BSC	Bahrain
02/28/92	Banco Atlantico SA	Spain	Arab Banking Corp BSC	Bahrain
03/10/92	ALUBAF Arab International Bank	Bahrain	Libyan Arab Foreign Bank	Libya
03/25/97	Banco ABC-Roma SA(Globopar)	Brazil	Arab Banking Corp BSC	Bahrain
05/19/97	Sarah Michaels Inc	USA	Bahrain International Bank	Bahrain
04/03/98	Thompson Products Inc	USA	Bahrain International Bank	Bahrain
08/04/98	Arab Banking Corp-Jordan	Jordan	Arab Banking Corp BSC	Bahrain
09/30/98	Hinditron Informatics Ltd	India	Taib Bank EC	Bahrain
01/11/99	Arab Islamic Bank	Gabon	Islamic Invest Co of the Gulf	Bahrain
03/17/99	Bomanton International Ltd	UK	Bahrain International Bank	Bahrain
12/20/99	Al-Ahli Commercial Bank	Bahrain	United Bank of Kuwait PLC	United Kingdom
02/24/00	TAIB Capital Corp Ltd(Taib)	India	Taib Bank EC	Bahrain
03/01/00	Islamic Invest Co of the Gulf	Bahrain	Faysal Islamic Bank of Bahrain	Bahrain
06/11/00	Centmat Retailing Trade Co	France	Bahrain International Bank	Bahrain
12/03/01	ABN-Amro Bahrain(ABN-Amro)	Bahrain	Bank Muscat Al Ahli Al Omani	Oman
10/01/02	Faisal Finance (Switzerland)	Switzerland	Shamil Bank of Bahrain EC	Bahrain

Part 2

Typology of the Causes and Effects of Merging

Introduction

M&A (merger and acquisition) activity has been intense in the industrialized West over the past decade, especially over the past few years, where the banking industry has undergone rapid consolidation. Indeed, on average over the past years, there were more than two mergers every business day in the U.S financial market. A marked result of this wave is the growth in the average size of banking institutions. Mergers have always occurred in waves throughout several points in history: the late 1920s, the late 1960s and most recently, in the early 1980s. The trend is toward blurring the boundaries that separated the various parts of the financial sector, particularly commercial banking, investment banking and insurance. More recently, the financial world has been faced with the formation of large financial conglomerates.

This part of the study will discuss three important issues in the field of bank mergers. The first section will provide an in depth analysis of the factors that motivate mergers; followed by a discussion of the inter-industry and intra-industry effects of merging and ending with the risk factors or the failures of merging.

The first phase of bank mergers occurred when the banking industry hit some hard times in the 1980s and early 1990s. Clearly, the traditional banking role of financial intermediation in which banks make loans that are funded with deposits, is no longer as important in today's financial system. The reason behind this decline in traditional roles is that, "fundamental economic forces have been eroding the profitability of traditional banking activities." (Mishkin, 2000)

The literature (which emanates primarily from the West, because merger activity is concentrated mostly there) measures bank performance and particularly, the efficiency dimension, using three primary tools: profits, operating costs and risk exposure. Banking is a declining industry faced with reduced demand for the intermediation services it produces. However, one may argue that the banking industry is not actually declining in any way, but it is the nature of its intermediation activity that

is changing. Banks have lost loan market share to non-bank lenders, and banks have also lost deposit market share to money market mutual funds.

2.1. The Numerous Motivations for Merging

A prime objective of research on bank M&As has been to identify motives for consolidation. The classic motives that have been discussed earlier include scale economies, scope economies and managerial x-efficiencies, which have been studied extensively. However, less attention has been given to the other two most frequently suggested motives for bank M&As: risk diversification and the wish to 'become too big to fail.' When a financial institution is "too big to fail," its activities make up a significant portion of an economy's payment system, credit-granting process or other key financial roles. As a result, any substantial disruption in an institution's operations would be likely to have a serious effect on a country's financial markets, either preventing the markets from operating properly or raising questions about their integrity. The consequences of the 'too big to fail' factor is that countries extend protection to large institutions and their customers that is not granted to others.

2.1.1. The "Efficiency" Argument

Academic economists and practitioners in bank regulatory agencies have been hard-pressed to identify systematic, merger related gains in bank productivity. Nevertheless, one of the most important efficiencies that is expected to result from mergers is the closing down of redundant bank branches, which will produce savings. There also appears to be a high probability that mergers between banks operating in the same geographic market will, indeed, close branches post-mergers.

Of particular interest to policymakers, market participants and researchers are the consequences of extensive consolidations on the efficiency factor and on the competitiveness of bank intermediation, for market liquidity and financial stability and for the workings of monetary policy.

Numerous studies have been conducted, especially in the period between 1980-1993, about the effects of bank mergers on three vital factors in the banking and financial world; efficiency, profitability and stockholder wealth. (Rhoades, 1994) Research results have been mixed. Some have revealed that there is no correlative relationship between bank mergers and improvements in performance, while others have shown that on average, mergers have led to significant productivity gains. In

effect, there is little support for the widely-held hypothesis that stipulates that bank mergers result in improvements in performance. It has been found that smaller banks are consistently more cost-effective than larger banks and profits were also lower at larger banks. In addition, some studies have shown that in-market mergers do not have more favorable effects on performance than other mergers. In-market horizontal mergers have the greatest potential for yielding efficiency gains because they provide the opportunity for closing overlapping offices as well as permitting like other mergers, the consolidation of back office operations, computer systems and administrative functions. This divergence in findings and economic opinions is indicative that economic feasibility of mergers and their benefits to the banks themselves and the communities, in which they reside at large will be an on-going debate.

Numerous empirical studies have found a statistically-significant, positive relationship between market concentration and profits, which upon closer examination, appears to derive from a link between market share and profits. Economists have differed in their interpretations of this finding. While one group argues that high levels of concentration allow firms to exercise market power, resulting in above normal profitability, another group argues that high levels of concentration and high profits are both the consequence of greater efficiency. Studies that have investigated the relationship between concentration and prices tend to support the market power interpretation, but the magnitudes of the positive, statistically significant coefficients relating to prices to concentration measures tend to be fairly small. Some empirical studies also suggest that high concentration and presumed lack of competitive pressure may also be associated with the failure of firms to produce efficiently.

Unless a relationship between ‘bigness’ and market concentration can be more firmly rooted in anticompetitive behavior, bigness, per se, does not appear to be an issue for national economic policy. Rather, it appears that bigness should be primarily the concern of shareholders whose returns could be muted by large company inefficiencies and their customers, who may face bureaucratic inflexibility.

It is argued that competition policies should address issues of productive efficiency, in addition to issues of allocative efficiency, and that industrial policies should improve the access of retail clients to investment funds.

Operating efficiency is a slippery concept, “if either a ‘capacity glut’ or a communications and data processing revolution explains the urge to merge, as mainstream theorists and the media continually assert, then we would see efficiency

gains post-merger" (Schenk, 2000), and that has not been the widespread case. The central impetus behind mergers has instead been equity-market based, indicating that the primal interest of the sector reflects gains in asset values for equity holders and in market share for bank executive officers.

Other studies have concluded that approximately one third of mergers have reported positive returns, declining costs, increasing profits or greater efficiency (Schenk, 2000), while the remaining two-thirds were largely unsuccessful.

However, in the final analysis, it is important to note that there is mixed evidence regarding whether bank mergers improve bank performance all in all, or not, relative to non-merging banks. It is also important to note that most mergers have occurred in the Western world, so our literature is largely a reflection of the West's experiences. Therefore, findings and conclusions by economists that bank mergers may not generally result in efficiency gains are not necessarily inconsistent with the argument by some bankers that mergers achieve significant cost-cutting benefits. Both groups may be right. However, they are usually tackling different concepts and different dimensions of the issue. The difference may arise from the fact that economists focus on the efficiency effects of mergers, which are typically measured by an expense ratio such as total expenses to total assets. However, in contrast, bankers typically focus on the 'dollar volume', or the percentage costs that will be cut. If dollar costs are cut following a merger, yet the assets/revenues decline, more or less proportionately (as a firm shrinks after a merger, which is not uncommon), the banker would rightly claim that costs were cut and the economist would rightly claim that efficiency in terms of costs to revenues or assets, did not improve. Nonetheless, from a public policy perspective and the real long-term performance of the industry, an efficiency measure is an appropriate benchmark. Altogether, only about 20% of mergers are to be considered successful, "the remainder being either waste or outright failure." (Schenk, 2000)

The economic literature shows that megabanks do not have greater operating efficiency than middle-sized banks. According to most studies, advantages due to size or economies of scale disappear once a bank reaches approximately $250 million in assets. (Dymski, 1999) In turn, the larger the size of a bank after this point is unlikely to achieve further economies of scale in banking operations. However, if operating efficiencies are not driving mergers, what is fueling the bank merger wave?

The issue of the optimal structure of a banking system has been much discussed in recent years within banking, political and academic circles. The optimal structure of a

banking system is discussed every time that the possibility of a merger or failure of a banking institution is mentioned. Numerous arguments in favor of, or against a merger between two banks, can be put forward. When any merger is proposed, one of the major concerns is that competitiveness of the sector could be diminished.

Free competition will improve the efficient allocation of resources in the economy, thus enhancing society's wealth and welfare. Increased competition in the banking system may lead to many conditions that include undue risk taking and thus reduced stability in the banking system. On the other hand, measures taken to increase stability in the banking system through mergers may lead to reduced competition. When a merger could cause a large concentration in a market or becomes highly concentrated, special attention should be devoted to its impact on competition.

High levels of concentration in any banking system could result in relatively high prices for banking services. However, it is difficult to compare prices before and after a merger in banking because of other factors, such as differential central bank policies and inflationary expectations. When a merger causes large market concentration, or when a market becomes highly concentrated, special attention needs to be given to its impact on competition.

A merger-related reduction in non-interest expenses would decline, suggesting a fundamental improvement in efficiency, whereas in fact the rise in interest expenses resulting from the change in product mix may have offset the gain. Mergers do not result in major changes in product mix. It is reasonable to analyze bank mergers for their effect on non-interest expense ratios, so as to assess the argument that mergers reduce non-interest expenses; nonetheless, analyzing interest expenses, which account for 70% of totals bank expenses.

The banking system's contribution to the efficient allocation of resources in the economy is reflected by its managerial ability to control input costs, (labor, physical capital and deposits) through the utilization of the returns to scale, scope and efficiency. Operating costs will eventually determine the optimal structure of the banking system in terms of the number of banks, size of banks, number of branches and possible mergers and acquisitions. Competitive markets are our best assurance that consumers receive the highest quality products at the lowest possible prices.

As long as barriers exclude international competitors, mergers may reduce competition and may hurt consumers. Bigger banks are not necessarily safer than smaller ones. Restructuring of the banking industry could cause constraints as

competitive pressures interact with stubborn cost structures and heightened incentives for risk taking. This trend is especially dangerous since bigger banks are more likely to view themselves as, “too big to fail.”

Bank profitability has decreased in numerous countries despite a wave of consolidation, mainly because acquirers tend, on one hand, to overpay, and on the other hand, to underestimate organizational problems. Most mergers have simply not delivered the benefits that were promised. A study by the U.S. Federal reserve concluded that approximately half of all mergers by what is designated as large banks, show eroded returns, whereas only about 17% produce positive returns.

Studies about bank efficiency and mergers have produced results that are so conflicting and sporadic, that no conclusive indicators or even remarks may be formulated to set some sort of rule or expectations, since patterns of behavior are quite inconsistent. Results are mixed even regarding the effects on performance of internal and external mergers. (Spindt, 1991) and (Linder, 1993).

Mergers may enhance value by raising bank diversification by either broadening the geographic reach of an institution and by broadening the breadth of products and services offered. This will do a number of things that include; increasing the number of customers, provide value and stabilize returns and lower volatility in shareholder wealth. However, the deviation between the actual costs and the minimum cost frontier for a given bank has shown that mergers have not led to no significant gains in x-efficiency. (Pilloff, 1997)

2.1.2. Cost Savings

There is skepticism over the cost-cutting benefits of merging. Relative to non-merging banks, mergers do not show significant efficiency improvements. Banks have costs typically 20-25% above those of the observed best practice banks, which would suggest the cost efficiency, could be considerably improved by merging. Again, such potentials may not be systematically realized in practice. The consensus is that bank M&As at best lead to very little improvements in internal efficiency. On the average, smaller banks tend to do better. It is important to note that in terms of size, all Kuwait banks are small, with the exception of the National Bank of Kuwait (NBK). Although this cannot be fully substantiated, findings are suggesting that the larger the merging banks, especially when their size is beyond a still quite limited asset size of $10 billion, the smaller are the chances for cost improvements. It is true that for the largest banks in

Europe and the remainder of the West, there is no significant relationship between size and profitability, which indicates either absence of market power and efficiency effects, or more plausibly, a compensation of market power gains by decreasing returns to scale. Since the technology revolution is one of the primary driving forces behind mergers, costs savings came as these advances were exploited to manage information databases, in sharing information among a large number of users and over wide distances. In other words, the benefits of the technology revolution were realized most fully by very large-scale banks (VLSBs) since their sheer size allows them to reap the benefits of economies of scale and expense sharing.

There is both theoretical and experiential evidence that shows that merged banks have reduced operating costs. Both labor and occupancy costs decline heavily after a merger. However, these findings become evident only after the pure accounting effects on reported expense data are removed. This indicates that merger accounting can hide a significant portion of cost cuts. Accounting methods used can be very deceiving and misleading, because they can over-value or under-value costs, hence a great deal of scrutiny is required to ascertain the objectivity of the accounting evaluation.

Operating Performance for Small and Medium to Large Bank Mergers Completed in 1986.

Table 2.1. Panel A: Small Bank Mergers

	Median Changes		*Control Adjusted Changes*		
	Merger Partners	**Control Sample**	**%Exceeding Overall Median**	**Median**	**% Positive**
ROE (%)	1.08	-0.21	59	1.29	64
ROA (%)	0.12	0.00	56	0.10	58
Leverage (%)	-0.04	-0.01	48	-0.19	53
Asset Turnover (%)	0.36	-1.06	52	0.21	52
Margin (%)	2.38	1.27	58	0.74	58
Employee Cost (%)	1.72	2.32	39	-1.19	42
Total Assets ($)	14,869	9,628	53	(2,481)	49

Source: Journal of Banking and Finance: Special Issue on "The Efficiency of Financial Institutions: “Performance Economies Associated With Changes in Small and Medium Sized Bank Mergers."

Table 2.2. Panel B: Medium and Large Bank Mergers

	Median Changes		*Control Adjusted Changes*		
	Merger Partners	**Control Sample**	**%Exceeding Overall Median**	**Median**	**% Positive**
ROE (%)	1.14	-0.67	59	1.53	63
ROA (%)	0.08	0.01	54	-0.08	57
Leverage (%)	-0.07	0.08	48	-0.06	51
Asset Turnover %)	1.57	-1.69	53	-0.21	48
Margin (%)	2.46	1.13	61	0.92	62
Employee Cost (%)	1.34	2.21	41	-0.87	40
Total Assets ($)	654,309	62,398	51	(2,111)	49

Bold percentages in columns 3 and 5 are significant at the 5% level of confidence. The performance measures are defined using book values: ROE is net income before extraordinary items as a percentage of stockholders' equity; ROA is net income before extraordinary items as a percentage of total assets; leverage is stockholders' equity as a percentage of total assets; asset turnover is total revenue as a percentage of total assets; margin is net income before extraordinary items as a percentage of total revenue; and employee cost is total salaries and benefits as a percentage of total revenue. Total assets are measured in thousands of dollars.

Table 2.1 reports median changes in five key operating performance measures and total assets for the merger partners (column 1) and the matched-pair control sample of non-merging firms (column. 2). We measure pre-merger performance pro forma by aggregating the performance of target and acquirer pairs of actual merger partners and of matched control firms for the two years prior to the merger year. We take the median (average) of these two observations as our measure. We use the median average performance of merged firms and the median pro-forma combined performance of matched control target acquirer pairs over the two years following the merger to measure post merger performance. Both small merging banks and medium to large merging banks experienced significant performance improvements relative to the control samples.

In both sizes of bank merger, improvements in margin relative to non-merging banks appear to be the primary source of the profitability gains. In medium and large sized bank mergers, for example, the median improvement in margin is nearly 2.5% compared to a median improvement of only 1.13% in the control sample of non-

merging banks than among their non-merging peers is at least partly responsible for the relative improvement in margin. The median increase in employee expenses among banks in the control sample was about 50% bigger than the median increase among merging firms for both large and small banks.

2.2. Inter-Industry and Intra-Industry Effects of Merging

The merger movement has had multiple and diverse effects on the economy at large. There are certain aspects of the economy however, that are particularly affected by mergers. When mergers affect another bank or financial institution, this is referred to as the inter-industry effects; however, when the effects of merging affect an economic activity that is not directly in the banking sector, such as small business lending or home mortgages, that is referred to as intra-industry effects.

Public attention has focused mainly on acquisitions of small banks by large ones, but in fact, the most prevalent type of merger involves the consolidation of two or more small banks. Concern about the potential effect of bank mergers on small business lending has stemmed from the belief that large acquirers may be less receptive than their target banks to being active in the small business lending market. We do find that acquirers tend to partially offset a merger-induced change in their small business loan portfolio share subsequent to a merger. However, mergers frequently raise small business lending of the consolidated bank because many mergers do not fit the stereotypical view of a large bank with few small business loans acquiring a much smaller target with a large portfolio share of small business loans. (Rosengren, 1997). It is found that acquirer banks tend to have a greater degree of specialization in small business lending than non-acquirers of the same size. It has also been found that large acquirer banks increased small business lending somewhat more than non-acquirer banks. Furthermore, acquirers in roughly half the mergers had larger small business loan portfolios than their target banks and furthermore, increased their small business loans after the merger in roughly half the cases.

In general, large acquirers are less active than small acquirers; nonetheless, many large acquirers have specialized in small business lending and have increased their portfolio share of small business loans after mergers. The fact that a merger occurs, or that an acquirer is much larger than its target, is not sufficient to determine the proclivity of the consolidated bank to engage in small business lending after the merger. The degree to which an acquirer bank is committed, in principle, to small business

lending is an important determinant of its likelihood to continue to do so after the merger.

The new structure of the banking industry may not have the negative impact that small business owners once assumed. In fact, some small businesses may realize benefits by working with larger institutions. Larger banks have higher loan to debt ratios; larger institutions are also generally more diversified, with loans and deposits from many areas, and are thus, better able to grant credit during downturns in a particular local economy. Larger banks also have a bigger customer base to spread costs for new technology. Traditionally, local community banks have more closely and efficiently monitored small business loans.

Evidence is mixed over whether or not small businesses' lending relationships suffer because of consolidations; in fact, some experts believe small business lending may actually increase through the use of new loan methodologies, such as credit scoring, that are more likely to be provided by larger banks. Credit scoring is a method of assigning a single quantitative measure, a score, to a potential borrower that reflects the borrower's relative risk of delinquency or default. Through credit scoring, large banks can lend more money more economically to small businesses.

The 'urge to merge' has been driven by the compulsion to grow in sheer size and market power, and also to be a more effective player in the global market. The financial sector, more than any other industry is affected by the growth of e-commerce; and its product; money is one that can be moved across borders electronically. Increasingly competitive markets mean that chief executives are feeling pressure from shareholders and boards to focus on M&As in an effort to improve returns. Due to inadequate planning and lack of preparedness, many mergers fail to live up to their planners' expectations, and many simply fail. It is important to note that the greatest chance of merger success lies in pre-merger feasibility.

Small banks specialize in small business lending, not large businesses, because they have a dollar ceiling as far as their allocation of loans to small businesses. Because small businesses may be particularly dependent on bank lending to finance their activities, the reduction on small business lending to banks could hurt the efficiency of the economy. However, empirical evidence is mixed over whether bank consolidation will lead to a reduction in small business lending or not. Some research findings (Mishkin, 2000) show that small bank lending is unlikely to be reduced as a result of

bank consolidation, while so many variables are involved and conditions and assumptions are prone to change, so that predictions are difficult to make.

A second possible negative outcome of bank consolidations is the rush of banks to expand into new geographic markets, and this may expose them to greater risk, which may lead to increased bank failures.

2.3. The Criticism of Bank Mergers

Mergers potentially produce two kinds of anti-competitive impacts: unilateral effects arising because the merged firm may exercise significantly more single firm power than its components each possessed pre-merger, and coordinated effects, occurring if a merger enhances the ability of firms to engage in various forms of anti-competitive parallel behavior. The risks of coordinated effects are especially significant in oligopolistic markets. It is important to note that Kuwait's banking sector may be considered oligopolistic in that a few banks control the lion's share in the sector. In addition to fewness, there are a number of other aspects that contribute to increase the risk that certain banking mergers may produce coordinated effects. These encompass a number of factors that include history of regulation, i.e. price and quantity control, high barriers to entry, inelastic demand for some products, such as transaction accounts, homogenous products, reasonably transparent and easy to monitor prices, a high degree of predictability of demand and costs and a high level of industry cooperation.

Financial theorists, suggest that mergers, like any other investments decisions, should only occur because they are a positive NPV project that maximizes wealth or market value of the acquiring firm's shareholders. However, besides the specific hypotheses of maximization of shareholder's wealth, there are a number of other reasons motivating bank mergers. The ***information hypothesis*** suggests that some banks bid for others because they posses private information about the targets that enable them to identify undervalued firms. The ***market-power*** hypotheses claims that banks merge to gain monopoly power, especially through horizontal mergers. Such merger enables the acquiring bank to raise their product prices after buying up their competitors. For example, the merger of Chemical Bank and Manufacturers Hanover; the marriage of these two money-center banks (July, 1991) resulted in the second largest retail franchise in the New York City area after Citicorp.

The ***manager-utility-maximization hypothesis*** suggests that some merger decisions are also made to satisfy managers' personal interest. Since larger firms tend to

pay higher compensation to their top managers, one way to maximize executive compensation is to maximize the size of the bank. The ***inefficient-management hypothesis*** contends that banks with weak managers or failing banks are potential takeover targets because the existing managers are not maximizing the value of the bank. For instance, small banks and thrifts with financial difficulties offer acquisition opportunities for community banks. For example, in the spring of 1991 the Resolution Trust Corporation (RTC) announced the sale of 34 S&L branches in Iowa.

The ***prospect of fresh capital*** is another lure towards M&A. One of the banks most compelling concerns is access to capital, and mergers could provide the quickest route to acquiring it. Mergers, especially those serving in the same market, lead to cost savings, which in turn free up capital. Additionally, bank stocks have enjoyed a dramatic comeback in recent years, and Wall Street is betting that the increase rate in mergers will attract a flock of investors. For example, when the merger between Bank of New York and Fleet Financial Corporation was announced in April, 1994, the market responded eagerly. Fleet's stock closed at $39.625 up $1.125, a 52 week high.

However, perhaps the most compelling reason behind M&A relates to the ***synergy hypothesis***. Not only do mergers expand market share, but they also produce cost savings. The ***benefits*** of a bank merger can be stated as the difference between, (1) the total present value of the merged bank, and (2) the sum of their present value if they do not merge. If **V** represents the value of the bank, and **B**, the benefits

$$\mathbf{B = V_{Bank1\&2} - (V_{Bank1} + V_{Bank2})}$$

The fact that $\mathbf{V_{Bank\ 1\&2}}$ is greater than the sum of $\mathbf{V_{Bank1}}$ + $\mathbf{V_{Bank2}}$ makes mergers worthwhile.

This possibility of high potential cost savings, lie at the heart of present merger activity. A significant number of banks merge in an attempt to gain efficiency, reduce costs, improve spreads on deposits and eliminate redundant assets. The synergy hypothesis contends that banks can save money by reducing operating expenses associated with redundant branches.

Bank branches are basic means available to banks for delivering their products. A 1993 US banker survey indicated that some $7.1 billion in commercial banks and thrifts deposits were transacted through branches during the 12 months ending November 30, 1992. Unfortunately, this method of delivering services is also extremely costly. Thus, as banks search for consolidations and greater efficiency and lower costs, bank's branch structures have become a top cost control priority. **The Economist** (January, 1991)

reported on a joint study by Keefe, Bruyette, & Woods, a stockbrokerage specializing in bank share, and Ernst & Young. This study found that when two banks of the same market merge, savings can reach 30% of the smaller institution's overheads, and can double the profitability of the combined bank. For example, the merger between New York's Chemical Bank and Manufacturer's Hanover, led to the closure of 70 branches, which resulted in the elimination of 6,200 employees, and saving of $650 million per year were projected. Savings following out-of-market or geographic acquisitions could lead to an estimated saving of 15% of the target bank's pre-merger non-interest expenses.

Mergers are attractive to regulators and bankers because they are considered the best vehicle for realizing efficiencies and profitability gains. At this point, it is important to distinguish between cost savings and improvement in efficiency. Some post-merger cost savings could simply be due to the shrinkage that results from the bank's size rather than any **real improvement in efficiency**. Cost reductions can occur due to reducing the number of employees, reducing branches and so forth. That is, such reductions correspond to reduction in assets, which represents shrinkage of the firm rather than improvements in efficiency. Only those cost savings that result from improved efficiency would help the troubled banking industry by creating competitive institutions and benefiting the public.

It is also important to note that **no two banks** will experience similar post-merger synergistic gains, nor are there any guarantees that synergistic gains will **always** flow to mergers. Over the last few years, a number of studies have been completed and published about the challenges and the conventional wisdom in the banking industry that proclaims that **all** mergers generate savings and efficiencies. There are three key reasons why some deals fail to realize merger gains:

1) Efficiencies were hard to come by,

2) Bigger did not mean better, and

3) Benefits were tough to predict.

Efficiencies were hard to come by

From the standpoint of reducing facilities costs, on paper, regional mergers make sense. In theory, the bank will be able to generate savings quickly by reducing the number of branches and headquarters offices that the new merged bank will no longer need. Unfortunately this is just theory. The reality is sometimes quite different as portrayed by the mergers of the 1980s. These mergers showed no significant savings basically because **they failed** to cut costs and raise productivity, making the combined bank marginally less

profitable. In fact, some Federal researchers suggest that the industry would have benefited more had the banks improved their operations as 'inefficient' banks than by consolidating to cut and overlap costs.

For example, in 1991 the large scale deal-makers were claimed to be meeting ambitious saving goals. BankAmerica Corporation had cut 3,700 jobs since its acquisition of Security Pacific. Chemical Banking Corporation reduced its payroll by 4,300 since announcing its merger with Manufacturer Hanover Corporation. However, many banks that had remained independent were making similar cost savings. These banks were achieving these savings through the adoption of cost control programs and improvements in their banks' efficiency.

Economist Srinivasan with Atlanta Feds, drew a similar conclusion from her study of bank mergers in the 1980s. Srinivasan studied all bank mergers that occurred between 1982 and 1986; four years after these deals had been consummated, Srinvivasan found that merging banks experienced small but significant decreases in costs during the third and fourth post-merger years. Non-interest expenses, mainly salaries and other bank overhead costs, fell by 4.8% in the merged banks. However, these savings were easily matched by banks that had not merged. Savings from salaries and branch overhead costs were offset by increases in advertising and goodwill amortization costs. This suggests that the banks did not achieve significant additional economies in consolidating back office operations.

Bigger doesn't mean better

Banks do not become efficient simply because they get larger. Most studies find that there are significant economies at small- to-medium-sized banks. For example, Spindt and Tarhan -1991 used data of 300 mergers (in 1986) of banks with an asset base of $26 million to examine the issue of synergetic gains from bank merger. The study found these banks (medium sized) had a better likelihood of realizing potential economies of scale, especially if target banks were under performers prior to the merger, and the acquiring banks were normal performers, the merged institution's return on equity tended to increase. However, the cost advantages for large firms are not clear. The large banks that have merged in the last few years are already larger than the most cost-efficient size. Srinivasan states that bank surveys typically disclose, that in a merger of equals, neither bank has the capacity to absorb data processing and back-office operations of the other.

Finally, the sheer size of large mergers creates concerns about employee morale, turnover and balance of power, that can paralyze banks and prevent them from taking

prompt, decisive actions. For example, dozens of special interest groups across the United States contend that large consolidations will lead to sprawling banks that will not be responsible to community needs. Still other groups are concerned with social costs of bank mergers. Cost savings from reducing staff (down-sizing, sometimes referred to as right-sizing) is one of the biggest benefits of a merger.

Benefits are tough to predict:

Several bank surveys have found that even efficient banks have had a tough time producing cost savings after buying other banks. Sherrill Shaffer (1991, conducted a study to stimulate mergers between banks with more than $1 billion in assets in order to predict potential cost effects of mergers. The simulation looked at contributions from economies of scale, product mix economies, branch closings and efficiency. The model predicts that an average merger yields a 0.98% decrease in the predicted total costs (1.08% omitting branches) compared with the sum of total costs of the unmerged banks. However, this is based on the premise that the merger is done right, i.e. the merger premium is priced accurately and steps are taken to reduce post merger costs. If the bank overestimates the cost savings from the merger or underestimates the acquisition cost, they could risk overpaying because they will be relying too heavily on cost savings to provide higher profits. One of the reasons why some of the mergers of the 1980s failed to realize merger benefits was because they paid too much for the target bank (over-priced deals). A typical merger premium paid was two to two and a half times the value of the target bank, thereby making the task of recovering the premium a formidable challenge. In addition, anticipated events, such as hidden loan losses or even poor timing, can eat into potential merger benefits and affect the profitability of the merged bank. Similarly, political considerations and incorrect timing of the merger can make best-planned mergers lose momentum. The nation's second-largest bank is suffering from growing pains.

Another cherished theory of pre-merger bankers is that merging banks with overlapping markets **(horizontal mergers)** will yield bigger cost savings, as the combined banks closed redundant branches and back-office operations. This would also allow the merging banks to spread their respective products across a broader customer base and become more efficient. Stephen Rhoades' study indicated horizontal bank mergers failed to always yield efficiency gains. Rhoades, conducted a set of tests to determine whether banks involved with horizontal mergers achieved efficiency improvements relative to other firms. The analysis covered 898 bank mergers from 1981 to 1986. Efficiency was

measured by using various expense ratios. Notably, the findings were based on mergers that were believed to be most likely to result in efficiency gains, that is they were horizontal mergers. A 1991 study by Berger and Humphrey could not find any correlation between the degree of market overlap and success at cutting costs. Another problem with in-market mergers is the deepening concentration of geographic risk. Many banks develop an inward, even a regional orientation after a merger. Of course, this would not be appropriate if the motivation for the merger was to consolidate operations and leverage market coverage. An unpublished United States Federal Reserve study also cast doubts on the savings potential of branch closings. The researchers found, after completing a study contemplating every possible in-state, big-bank merger and closing half the overlapping branches, that only 2.7% of the nation's 58,603 bank offices would undergo closure.

2.4. Risk Factors

The fundamental objectives of a financial services institution, whether it be a bank, insurance company or securities firm, are firstly, to be financially safe and sound; secondly, to obtain the confidence of and show fairness to the ultimate end-users and shareholders of the establishment; and finally to operate as an efficient and effective organization. These objectives should always be consistent with the objectives of the regulatory authorities of each country. The essential objectives of the regulator are to:

1. Ensure a sound and stable financial system.
2. Ensure an efficient and effective financial system.
3. Enhance the sense of confidence and fairness in investors, by eliminating bad business practices and ensuring healthy competition between financial institutions.

The element of risk in banking refers primarily to the risk of insolvency. For the analysis of risk, we typically compare the acquirer’s risk one year after acquisition with its risk one year prior to acquisition. This dimension of banking is of utmost importance, especially on the macro-economic scale, due to the grave repercussions that may result from insolvency in a banking institution in a given economy. The liquidity and or solvency problems of large banking institutions are precisely those whose negative externalities are perceived as threatening to financial stability. The outright failure and liquidation of a large bank comes at a large social cost. Research has shown that banks operating in developed financial markets exhibit lower insolvency risk, while banks

operating in economies that are over-regulated with respect to the permissible activities pertaining to banking, exhibit a higher risk of insolvency (Gianni, 2000).

In practice; however, the concept of risk also pertains to the ability of existing banking theories to rationalize key aspects of the cross-sectional relationship between size, charter value and risk. The relationship between bank size, charter value and risk are documented by means of simple cross-sectional regressions, tailored consistently to the banking industry equilibrium.

Measuring risk is an important and critical issue, equally important to risk in and of itself. There are two primary methods to measure risk:

1. Total relative risk; and
2. Systematic risk.

Total risk measures the variance of a firm's stock. Systematic risk, on the other hand, measures the rise and decline in the share of income of a domestic bank when it acquires a foreign bank. It is, therefore, expected that after the merger, the acquirer's return will show a weaker covariance with the home market banking index, and a stronger covariance with foreign market banking indexes, the world as a whole, and particularly, where the target bank is located. Systematic risk is the possibility that the failure of one bank to settle transactions with other banks will trigger a chain reaction, and cause a domino effect, depriving other banks of funds, and in turn, preventing them from losing their positions. The consequence is loss of confidence in the whole banking system. Hence, the effects of consolidation on systematic risk should not be viewed lightly, since detrimental repercussions could extend beyond a single institution and spread even to the entire financial sector, which may eventually result in a sector-wide financial crisis.

The first risk-increasing effect is produced from the incentives banks have to risk when the regulatory "safety net" and its associated implicit guarantees are under-priced. One way in which the safety net may be exploited is for a bank to acquire other risky banks by cross-border expansion. If the risky investment pays off, then the acquiring bank has the potential to keep any upside returns. If the acquisition of the foreign target fails and the domestic bank's (the acquirer) solvency is threatened, then the acquiring bank may be bailed out, either by its own home or domestic regulator or perhaps by the host regulator, (i.e. regulator of the target bank). As a result, cross-border mergers may increase the insolvency risk exposure of either one or both of the domestic and host bank regulators. A second reason why cross border acquisitions may increase

an acquirer's risk spread is by extending its operations into new overseas markets. The domestic bank would be confronted with potentially new and risk-increasing monitoring problems related to the loan customer base and the operating cost structure of the target bank. If monitoring costs are high, these problems may also increase the insolvency risk of the domestic acquiring bank and implicitly the risk of the domestic and foreign regulators.

Another dimension of risk is concerned with risk diversification, rather than the risks of mergers in and of themselves. Risk diversification is a very important issue for banks and players in the financial sector and it plays a significant role in bank merger policies. Geographic diversification is naturally risk–reducing, because socio-economic and/or political turbulences in one region or area may be offset by stability and good economic returns in other geographic regions. When banks consider merging, they choose targets that allow for a significant reduction in their risk exposure; merging partners that will complement their business portfolio.

Despite the importance of this debate, little is known about the risk effects of bank M&As. On the one hand, the research on post-merger effects has concentrated on performance, indicated by costs and profits and on the changes in asset management (composition of the bank's portfolio of assets) resulting from the merger or acquisition. The end result has mixed effects on the banks' capital asset ratio.

The overall question as to whether cross-border mergers are net beneficial and to whom (bank owners, bank regulators,…) remains open and debatable. If cross-border mergers do not raise the risk of the acquiring banks relative to other domestic banks, which indeed reduces their risk, then domestic regulators may encourage domestic banks to expand abroad. By contrast, if cross-border mergers increase the relative domestic "riskiness" of the acquiring bank, then domestic regulators may wish to scrutinize such mergers more carefully and may even seek to restrict them to decrease the safety net subsidies and reduce risk-shift behavior. Similarly, with respect to the target or host country, if the foreign acquiring bank's risk rises relative to the risk of the host country banks, then foreign acquisitions may be viewed as undesirable in that they increase the insolvency risk of that host country's banking system.

In spite of the fact that the risk factor is improved and reduced in most bank merger studies in this field, studies have found that risk diversification is not in itself a major force driving bank acquisitions (Craig and Santos, 1996). This also indicates that reducing risk is not one of the primary forces that drive mergers, though it is one of the

automatic benefits of merging. Recent consolidations in the banking industry are producing less risky organizations. At the same time, it is creating larger institutions for which the 'too big to fail policy' is potentially more valuable.

Information technology systems should be able to provide management with information that is timely, accurate and relevant to manage the bank's risks. A bank's system should be integrated, involving minimal intervention; with risks emanating from the various departments and/divisions being consolidated at the management level. In any merger, the significant time spent to merge various systems can be seriously detrimental to the ongoing business of the bank. Implementation of information technology systems is one of the biggest decisions and risks for a merged entity to decide upon.

2.5. The Conditions Required for a Successful Merger

It is impossible to lay down a holistic framework or set of conditions that will make a merger successful. However, practitioners in the field have agreed upon a number of merger imperatives that include;

- Determining and communicating a crystal clear strategy for the organization
- Coordinating and rapidly managing the transitional process
- Communicating and leveraging the new cultural standards and realities
- Designing the way work will be conducted in the newly forged establishment
- The new management should quickly gain control over the new merged entities
- The new management should also be prepared to repel attacks from vultures feeding on vulnerable customers and employees
- A clear and planned rapid integration methodology that explicitly focuses on capturing the projected merger benefits that include people, assets, cost efficiencies, revenue and cost synergies

2.6. Conclusion

Bank consolidation is the result of fundamental economic forces, which have increased competition and improved the efficiency of our financial system. Furthermore, because bank consolidations will increase diversification of banks' portfolios, it makes it less likely that we will have bank collapses; the increased

diversification resulting from consolidations should; therefore, make for a healthier banking system, which is less prone to banking crises.

An important lesson from the American and European experience is that from now on, credit institutions can no longer contemplate their future without carefully thinking about changes in their economic, legal and financial environment. Recent research has shown that improvement in profitability is not an economic consequence of a merger. To be effective merger deals need to be part of a strategic plan and the emergence of trans-national banking groups will bring new risks, requiring closer cooperation between national banking supervisors. (Schenk, 2000) Recent studies have also shown that improvement in profitability has not necessarily been related to size and that the definition of optimal size varies according to the type of institution, activity and business conducted. Compatibility of respective information systems might cause specific difficulties, the handling of which may be a delicate matter. The increasing number of decision-making centers and structural differences may affect the efficiency of internal control systems. Some deals have revealed problems relating to the integration of different corporate cultures. The reconstruction of a banking group, or mergers within a banking group, or the acquisition of subsidiaries, joint ventures and branch offices by banks or their controlling companies should be in the interest of the stability of the banking system as a whole

After reviewing numerous extensive studies that have been conducted on bank mergers, it seems clear that consolidation is not producing significant efficiencies, at least not on average. Up to 1996 and based on the data and experience present up to then, a number of conclusions may be deduced:

1. Consolidation has had a minimal effect on the efficiency of the banking industry.
2. The bulk of mergers have occurred amongst the relatively large banks, which have had the least potential to realize efficiency gains due to economies of scale. However, empirical work (Boyd, 1996) has shown that when small banks do merge, the average result is significant gains in cost efficiency and profitability.
3. It is important to note; however, that small bank mergers are simply too infrequent; and involve too small a share of industry assets, to have any significant affect on the industry’s performance, at large.
4. Recent years have witnessed an extremely profitable banking industry, but there is no reason to believe that consolidation was the cause; factors need to be

isolated to correlate variables. In such an environment, the efficiency and risk effects of consolidation are difficult to ferret out.

Overall, the operating performance (OP) studies provide substantial evidence that, in general, bank mergers do not yield performance improvement in terms of profitability or cost efficiency. The operating performance methodology permits the researcher to focus specifically on costs and efficiency; the general methodology of OP studies is to analyze changes in accounting profit rates or cost ratios, or both, before and after merging (Rhoades, 1994).

In-market mergers do not have performance effects different from those of other mergers. Mixed evidence suggests that acquired firms tend to be average performers rather than poor performers. When studies are weighted, the overall conclusion is that bank mergers have not generally resulted in significant efficiency gains.

Table 2.3. Cross-Border Bank Mergers by Nation

Nation	Acquirers	Targets	Nation	Acquirers	Targets	Nation	Acquirers	Targets
Albania	0	2	Gibraltar	0	1	Norway	6	18
Andorra	0	2	Greece	14	8	Oman	1	3
Argentine	9	51	Guernsey	1	3	Pakistan	1	2
Armenia	1	0	Hong Kong	33	72	Panama	1	5
Aruba	0	1	Hungary	4	49	Pap.N.Gui	0	1
Australia	53	51	Iceland	1	0	Paraguay	0	2
Austria	54	28	India	0	13	Peru	1	21
Bahamas	1	4	Indonesia	5	30	Philippines	4	30
Bahrain	15	3	Ireland-Rep	31	20	Poland	8	91
Bangladesh	1	0	Israel	1	9	Portugal	37	36
Barbados	2	0	Italy	100	108	Puerto Rico	1	1
Belarus	0	2	Ivory Coast	4	3	Romania	1	12
Belgium	75	42	Jamaica	0	3	Russia	15	24
Bermuda	8	1	Japan	91	7	Saudi Arabia	8	0
Bhutan	0	2	Jersey	0	2	Singapore	36	9
Bolivia	0	2	Jordan	2	1	Slovak Rep	4	7
Bosnia	0	3	Kazakhstan	0	3	Slovenia	1	3
Botswana	0	1	Kenya	0	1	S. Africa	30	16
Brazil	7	54	Kuwait	7	0	S. Korea	9	17
Brunei	1	2	Latvia	2	23	Soviet U.	2	0
Bulgaria	1	10	Lebanon	2	10	Spain	144	106
C. Afr. Rep	0	2	Libya	5	0	Sri Lanka	0	5
Cameroon	0	1	Liechtenstein	5	3	Supranat.	1	0
Canada	76	35	Lithuania	1	11	Sweden	57	17
Cayman Is.	4	3	Luxemburg	28	36	Switzerland	128	73
Chad	0	1	Macedonia	0	6	Taiwan	13	7
Chile	4	27	Madagascar	0	1	Tajikistan	0	1
China	16	5	Malawi	1	1	Tanzania	0	2
Colombia	6	19	Malaysia	23	15	Thailand	0	30
Costa Rica	0	1	Mali	0	1	Togo	0	1
Croatia	3	18	Malta	1	4	Tonga	0	3
Cyprus	1	2	Mexico	5	30	Tunisia	2	2
Czech Rep.	5	30	Moldova	0	1	Turkey	8	6
CSFR	0	3	Monaco	2	5	Uganda	0	2
Denmark	24	19	Morocco	2	10	Ukraine	1	8
Dom. Rep	0	1	Mozambique	0	4	U.K.	205	184
E. Germany	0	3	Namibia	1	0	U.S.A	274	274
Ecuador	4	1	Nepal	0	1	U. A.E	1	0
Egypt	2	6	Neth Ant.	4	3	U. Volta	0	2
El Salvador	0	4	Netherlands	122	38	Uruguay	0	7
Estonia	8	22	New Zeal.	5	32	Uzbekistan	0	1
Fiji	0	2	Nicaragua	0	1	Vanuatu	0	1
Finland	17	16	Nigeria	0	2	Venezuela	7	16
Fr Polyn.	0	1	Norway	6	18	Vietnam	0	4
France	219	159	Oman	1	3	Virgin Isl.	1	1
Gabon	0	1	Pakistan	1	2	Zaire	1	2
Germany	228	84	Nicaragua	0	1	Zambia	0	1
Ghana	0	1	Nigeria	0	2	Zimbabwe	0	4

Part 3

Merging Policy and Regulation

Introduction

The financial system is composed primarily of several elements that include depositors, banks, entrepreneurs and regulators. Financial institutions operating in any country are obliged to follow regulations enforced by the central monetary authority (CMA), designed to better serve the public and the national interest. The major objectives of regulating the banks are to reduce the risk of failure and to achieve some desired social goals. Bank regulations are designed to prevent commercial banks from becoming too risky, and thus, to maintain public confidence in the country's financial and banking system. The economic argument for regulation is that banking, by its very nature, is risky and is prone to market failure. The social costs of such a failure exceed the financial costs of regulating the banking system. Regulations must be balanced and limited, so that: (i) banks can develop new services according to the public demands, (ii) to ensure that the competition in financial services will remain strong (iii) to provide adequate quantity & quality of service to the public and (iii) to avoid waste of scarce resources. While the reasons for bank regulation are well known, the possible impacts of regulation on the industry are in dispute (For example, see Corringan (1985-86), Rose (1999), Spong (1994); and Hoening (1997). Stigler (1971) is the pioneer in developing theories of regulation. According to Stigler, firms in regulated industries actually favor regulation because it reaps benefits in the form of monopolistic rents. Banks may lose profits because regulations are removed; as a result, they will no longer enjoy protected monopoly rents. Peltzman (1976) argues that regulation protects a firm from changes in demand and cost, and lowers its risk. This implies that removal of regulations would involve a bank in greater risk, and eventually, more bank failure. Kane et al. (1983) have argued that regulations can increase customer confidence in banks, which in turn, may create greater customer loyalty toward banks (Kabir, 2002).

There are four main interactive forces that primarily drive bank mergers, and they include; regulatory reforms, on-going globalization in both financial and non-financial markets; excess capacity/financial distress; and technological change,

including the development of electronic banking. Up to this point, bank mergers have occurred among banks based in the same national market, but there is an increasing incidence of cross-border deals in OECD countries since the remaining regulatory barriers are minimal, though political barriers remain with a strong foothold. It is important to note that numerous countries have regulations that discourage the foreign takeover of domestic banks. Bank regulation is justified as necessary to correct ‘market failure.' When considering bank mergers, the initial consideration is to conduct a preliminary market assessment to determine whether competition will be harmed, based on the resultant concentration ratios.

Bank mergers posing risks for competition are often justified on the basis of certain efficiency benefits, such as economies of scale and scope and/or reductions in risk obtained through loan diversification. Banks have been losing part of their traditional business as more and more large enterprises turn directly to capital markets.

Bank regulators, who have great interest in the financial soundness of banks, rely heavily on ROA (return on assets) and other accounting measures to assess the performance of banks. The regulatory framework within which supervision takes place in the United States, together with the authority, powers and responsibilities of the regulator, is provided by:

- The Banks Act, 1990 (Act # 94 of 1990, the Banks Act, and the Mutual Banks Act, 1993, Act # 124 of 1993)
- The core principles for effective banking supervision
- The regulations relating to banks and regulations relating to mutual funds

The regulatory framework within which supervision takes place is provided by three entities:

1. The banks Act of 1990 (Act # 94 of 1990).
2. Regulations relating to banks and to mutual funds.
3. The core principles for effective banking supervision (issues by the Basel Committee on banking supervision in 1997). However, it is section 54 (on mergers) in the Banks Act that lays down the legal framework for mergers and the core principles.

The sections of the Banks Act that have a bearing on reconstructions and mergers and acquisitions are the following: Section 37, on restrictions on shareholding by specifying the percentage or the predefined levels that shareholders would need to seek permission to increase. The percentages that require such permission are 24%, 49%

and 75%. Permission for the acquisition of shares in a bank or bank controlling company is not given lightly and is granted only if the Registrar of banks, and when required, the Minister of Finance, are satisfied that the proposed acquisition of shares is not contrary to the public interest and is also not contrary to the interest of the bank concerned or its depositors or the controlling company.

Essentially section 54 on mergers, provides that no compromise, amalgamation or arrangement that involves a bank as one of the principal parties to the relevant transaction, and no arrangement for the transfer of all or any part of the MOF is obtained, unless the minister's consent is granted, in which case, three conditions must be met:

1. The transaction in question will not be detrimental to the public interest.
2. Amalgamation of banks only.
3. In the case of a transfer of assets and liabilities that entails the transfer by the transferor bank of the whole or any part of its business as a bank, such transfer is affected to another bank or a person approved by the Registrar.

Principle 5, 20 and 23 of the core principles also set and shape the legal system designed for mergers. In terms of principle 5, "banking supervisors must have the authority to establish criteria for reviewing that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision." (Schenk, 2000) From a supervisory perspective, it needs to be determined whether the banking organization has both the financial and the managerial resources to fund the acquisition. We may also need to consider whether the interest is permissible under the existing banking legislations. Banking, by its nature, entails taking a wide array of risks. The supervisory body understands these risks and needs to be satisfied that banks are adequately measuring and managing the risks effectively. An additional essential element of banking supervision is the ability of the supervisory body to supervise the banking group on a consolidated basis. This includes the ability to review both the banking and the non-banking activities conducted by the banking organization, either directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign offices. In this regard, it is important that we as supervisors take into account that the non-financial activities of a bank or group may pose risks to the bank. In terms of principle 23, concerned with 'obligations on home country supervisors', "banking supervisors must practice global consolidated supervision over

their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations world-wide, primarily at their foreign branches, joint ventures and subsidiaries. Based on the above, we should take responsibility of our internationally active banking organizations, and in order to assume this responsibility, we should be comfortable with the risks facing these entities and the manner in which these risks are managed.

Banking groups vary widely in terms of structure, range of activities and complexity. This could complicate the effective supervision of banks within such groups. Furthermore, users of banking services must be able to make a proper assessment of the banking group's activities and risk profile. The general philosophy behind the supervision and regulation of bank controlling companies and their subsidiaries is to ensure that banking groups do not affiliate with companies engaged in undesirable practices. Banks controlling companies should confine their activities to the management and control of banks and companies engaged in activities considered to be closely related to banking. However, because of the nature of their business, banks tend to invest more in companies that are primarily involved in financial services or activities. Hence, financial activities should preferably be structured under a bank, whereas non-financial activities are normally structured under the bank controlling company. In the supervision of financial conglomerates, the primary concerns are contagion, transparency and autonomy. When liquidity and solvency risks manifest themselves in any member of a group, the likelihood of contagion of the banks in a group is a major concern.

3.1. Managerial Structure

It is a known fact that by far the most common underlying cause for bank failure is bad management. Monitoring relies heavily on the competence and integrity of management. Therefore, the following should be borne in mind:

1. Only managers and management should manage banks with a proved ability and integrity to pursue the interests of shareholders, without harming the interests of depositors.
2. Management should put the interests of depositors and the organization first.

3. Several aspects relate to capital; capital adequacy is a vital measure of the solvency of a banking group and a significant indicator of the level of protection that the banking group has against risks. Ensuring adequate levels of capital promotes public confidence in the particular banking group and the entire banking system. A merged entity should have adequate capital to meet both regulatory requirements and its own internal requirements, taking in to account its risk profile. (Schenk, 2000)

Capital is important for a number of reasons: It provides a permanent source of revenue for shareholders and funding for the bank. It is available to bear risk and to absorb losses; it provides a base for further growth and it gives shareholders reason to ensure that the bank is managed in a safe and sound manner. Minimum capital adequacy ratios are necessary to reduce the risk of loss to depositors, creditors and other stakeholders of a bank and to help us to pursue the overall stability of the banking system. The Basel Committee on Banking Supervision recommends that supervisors should apply the minimum capital ratio of 8% to all internationally operating banks on both a solo and a consolidated basis. In a merger or an acquisition, any current or consequential cross-shareholding should also be eradicated in order to avoid double accounting of capital. We also have to assess the ability of the major shareholders of a merged entity to provide additional capital should the bank or banking group experience financial difficulties.

Safeguarding against excessive concentration of risk is one of the most important components in any system for the supervision of banking groups. Concentrations of risk cannot be eliminated; concentrations will arise through the specialization of banks for reasons of competitive advantage and expertise. The risk can and must be contained by ensuring that the exposure of a bank or a banking group is diversified. Banks should manage their credit risk prudently to ensure that there are no undue concentrations of risks to individual entities, associates, industries, geographic areas, sectors and banking products. Any merger of two or more banks should be in the public interest. A proposed merger should, therefore, add some depth to the local banking sector and make a worthwhile contribution to banking services and the banking sector. Competitive markets are the best assurance that consumers receive the highest quality products at the lowest possible prices.

Information technology systems should be able to provide management information that is accurate, timely and relevant to manage the bank’s risks. A bank’s system should be integrated, there should be minimal manual intervention, and the risks emanating within various departments/divisions should be consolidated in the management reports.

3.2. Extra-Regional International Policy

Even though under-recorded, services currently account for over one-third of measured trade. Nevertheless, multilateral trade liberalization in the services sector has lagged the merchandise sector by a very wide margin. Only during the latest round of multilateral trade negotiations (the Uruguay Round) did services become an integral element of trade liberalization efforts. A possible reason for the relative neglect of services in international agreements is that cross-border competition in services does not only take place through cross-border trading. Market access can also be gained through firms establishing residence in the jurisdiction in which they offer their services. In contrast, there exist a much more limited number of international agreements among sovereign states, which are directed, to enhancing both forms of competition. These agreements are treated chronologically below, with some emphasis placed on potential conflicts arising from bilateral and regional agreements having to do with the cross-border provision of financial services.

Unquestionably, the most important multilateral agreements affecting international trade in this area have been the OECD Codes of Liberalization of Capital Movements and of Current Invisible Operations. These codes provide for the progressive liberalization of capital flows and the provision of financial services on the basis of "national treatment," and they have been successively revised and updated since their promulgation in December, 1961. The broad scope of the liberalization commitments in the OECD codes can also be demonstrated in a more negative way by noting the difficulties which Korea is currently experiencing in gaining membership to the OECD.

The Free Trade Agreement, signed by the United States and Canada in 1989, was the first attempt to develop formal rules and disciplines for financial services in a trade policy setting. In this conceptual sense, it was revolutionary, but in practical terms, it was less so. The Agreement addressed some long-standing grievances about "access" within the Canadian and US markets, but it did not do so on the basis of any well-

articulated and forward-looking set of principles. Moreover, in the aftermath of the treaty, very little of consequence happened. Far from coming to dominate the Canadian financial scene, US financial institutions generally lost market share and a number of them withdrew from the Canadian market entirely.

In contrast, the North American Free Trade Agreement was based on a forward-looking set of principles designed more to enhance access than to simply preserve it. The search for principles was in part due to the desire to extend the NAFTA over time; transparent principles would ease such an extension. Beyond this, the US, Canadian and Mexican participants all hoped that these principles might serve as a model for trade agreements in other fora. Most importantly, at the time NAFTA was being negotiated, the future shape of the General Agreements on Trade in Services (GATS), and in particular, financial services, was still to be determined. Moreover, it was felt that successful implementation of a principles-based agreement, to which an important emerging economy was party, might provide an important precedent for regional trade agreements elsewhere. If so, shared principles underlying such regional arrangements might lessen the danger that they could get in the way of forging more global agreements. There were also less altruistic reasons for the Canadian and US governments to pursue this principles-based approach. Canada feared that, without clear principles in place, the United States would use regulatory change to the disadvantage of Canadian financial institutions. The US administration apparently felt much the same about the Mexican Government and wished as well to anchor trade liberalizing principles in a legally binding treaty, so as to condition future domestic legislation.

The broadest principle of all in the NAFTA recognizes that all firms providing financial services should have equal access to all customers in all participant countries, either through cross-border trading or rights of establishment and that there should be no discriminatory legislation. The treaty also emphasizes the need for transparency in all government decisions in this area; the need to recognize that national treatment must be de facto and not just de jure, and it lays down specific procedures for dispute resolution.

The treaty also lays down certain provisions with respect to supervision. Most importantly, supervision will continue to be host rather than home-based, though regulators can negotiate bilateral agreements providing for regulatory or supervisory harmonization. While NAFTA left in place the existing differences between the structures of the Canadian/Mexican and US banking systems (differences related

primarily to multi-branching and universal banking), its principles explicitly espouse universal banking, multi-state branch banking and international branch banking. The upshot is that the repeal by the United States of the McFadden and Glass Steagall Acts, would oblige Canada and Mexico to alter domestic legislation to bring these principles fully into play. In this altered world, it would not be inconceivable for the harmonization of regulations to proceed a very long way. Should this happen, it would also be more likely that host supervisors would come to rely more heavily on input from home supervisors. This would also be helpful for global developments since, as will be discussed below, a home-based approach to supervision is more or less the norm elsewhere in the world.

Not a great deal needs to be said about the European Communities Second Banking and Investment Services Directives, even though they are significantly more ambitious than the corresponding parts of NAFTA. The directives provide free right of establishment in member countries, a liberalized regime for the provision of cross-border services and a harmonization of essential rules across countries. The right to establishment throughout the community requires only a single license ("passport"), a feature which also applies to subsidiaries of firms from outside Europe. As for supervision, the directives lay out the principles of home country regulation and mutual recognition by EC members of each other's regulatory regimes. The Directives also stipulate certain capital adequacy standards for financial institutions as well as disclosure rules. The most recent international agreement in the area of banking and finance was the Financial Services Agreement (FSA) signed by seventy-six countries at the World Trade Organization in July 1995. This agreement is a sub-agreement to the General Agreement on Trade in Services, in that it dealt with services, was one of the major achievements of the Uruguay Round. The FSA is based on the traditional principles of ‘Most Favored Nation’ and ‘National Treatment’ and entailed a large number of countries offering binding commitments regarding specific areas of financial services. The effect will be to ease cross-border establishment problems as well as the provision of services across borders by non-established firms, particularly in emerging markets where the OECD codes have not thus far been widely applied.

After two full years of negotiations, the United States announced in June 1995 that it was dissatisfied with the liberalization commitments offered by a number of (mostly Asian and Latin American) countries. Under those circumstances, the United States withdrew its previous offers on financial services and decided not to accept the

MFN principle with regard to financial services. Foreign institutions already active in the United States; however, would be grandfathered. Given the competitive potential for US financial firms to expand abroad, this decision was understandable if still regrettable, as the United States, had up until that time applied an unconditional national treatment standard to foreign firms. The other countries that accepted the agreement have committed themselves to implement their liberalization offers before November 1997, when it was very much hoped that renewed negotiations will lead to the United States being able to participate more fully. The US authorities have still more recently taken a similar, tough stand at the WTO with respect to telecommunications.

There were also extended discussions, in the context of the FSA negotiations, about the need for adequate prudential regulations of those providing banking and insurance services. However, in the end, no agreements were reached and the final text includes only a statement of principle to that effect. Similar to the decision taken earlier to leave questions of exchange rate adjustment to another forum than the World Trade Organization, it was perhaps implicitly recognized that issues having to do with regulation and supervision might also be treated more effectively elsewhere. Increased international competition is clearly an important objective, but it must still be weighed against the other important goals of macroeconomic and systemic stability.

Central and Eastern European (CEE) countries have gone through a significant economic and political transformation during the last decade. As they moved away from state control to a relatively free market system, these countries launched wide-ranging economic and financial reform programs to stabilize their economies and to establish market forces as performance drivers. These reform programs typically entailed the liberalization of product and financial markets, restructuring and privatizing state-owned enterprises (SOEs), and elimination of trade barriers to open their markets to global competition. Since they did not have markets and institutions in a capitalist sense to start with, they tried to build these structures from scratch, while adjusting to an entirely new world. The strengthening and restructuring of the financial sectors and improving the supervision and regulation of banking and financial services received utmost importance as part of their efforts in the process of economic development. In pursuit of these goals, a series of regulatory reforms were designed and implemented to accelerate the liberalization of the provision of financial services. Throughout this transition process, the banking sectors have undergone massive restructuring and witnessed profound changes to cope with competitive pressures and market forces.

Privatization of state owned banks and the elimination of restrictions on domestic and foreign market entry has increased the number of commercial banks operating in their national markets and changed the competitive conditions in banking.

While the command economies of Europe were experiencing their own transformation to market economies, their western counterparts were marching toward the goal of European political and economic integration. The establishment of the European Monetary Union (EMU) and an optimum currency area constituted a giant step towards this goal. These developments are expected to have a substantial influence on the financial and banking systems of member countries, as well as the transition economies of CEE, with increasingly tighter links to the EU. Even before this phase, widespread deregulation and liberalization, accompanied by technological development and internationalization have significantly changed the competitive structure of the European financial services industry. After the implementation of the Second Banking Coordination Directive in 1993, banks from the European Union (EU) countries were allowed to branch freely into other EU-member countries. The new legislation, by exposing national banking markets to potential new entrants and making cross-border acquisitions and mergers practically free of all remaining obstacles resulted in intensified competition and substantial banking and financial industry restructuring in Europe. These new competitive conditions are likely to put more pressure on European banks to extend their cross-border operations into the potentially more profitable markets of CEE countries.

3.3. Regional GCC Policy

GCC banks have challenges and limitations that include the following: economies of scale, competition, modern management mechanisms and diversification of banking. It is very important to bear in mind that banks in the GCC region are relatively very small compared to their international counterparts.

Some of the most important benefits of consolidation, from a regional perspective, include the following:

- The elimination of geographic restrictions on banking will increase competition and weed inefficient banks from the industry, thus raising the sector’s efficiency
- The move to larger banks also means economies of scale
- New distribution networks, coupled with the elimination of geographic restrictions, allow banks to take full advantage of new technologies

The GCC is made up of Bahrain, Kuwait, Saudi Arabia, Oman, the United Arab Emirates and Qatar. In general, the region's sectors share much in common in that their regulatory and supervisory bodies perform similar duties and their experience with bank mergers is limited, if not non-existent. We shall discuss the cases of Bahrain, Saudi Arabia, Kuwait and Oman to capture the philosophy and outlook of the region's regulatory framework. Kabir, (2002) has conducted extensive research on the policy and regulation dimension of banking sectors of the GCC, which we will utilize certain aspects of, in the following section.

Bahrain

Provisions of the Bahrain Monetary Agency Law- No. 23 of 1973, which is amended from time-to-time, lay specific and general responsibilities on the Bahrain Monetary Agency (BMA) in relation to the licensing and supervision of banks operating in and from Bahrain. The Law provides for minimum capital and reserve requirements and authorizes the BMA to determine the types of business which banks may conduct. It entrusts the BMA with powers of inspection, which include a comprehensive system of quarterly and monthly statistical returns from banks. Under the Law, the BMA is empowered, in certain circumstances, to take over the administration of a bank, which can lead to liquidation.

Prudential information returns are required from all banks operating in Bahrain. The current requirements include quarterly prudential information returns, in addition to monthly and bi-annually statistical returns and yearly returns concerning management personnel and foreign exchange dealers. Other requirements include the auditor's management letter, together with the response from the bank's management.

Since 1992 the published accounts of locally incorporated banks have been directed to comply with International Accounting Standards (IAS). In the case of Islamic banks, separate arrangements are being developed. In 1997 the BMA instructed Islamic banks in Bahrain to apply five International Islamic Financial Accounting Standards (IFAS), and also, to publish this information as supplementary to their audited financial statements. In 1998, the BMA added three additional standards and required Islamic banks to comply with these standards in preparing their accounts. Branches of foreign banks in Bahrain were instructed to adopt British or American, Generally Accepted Accounting Principles (GAAP), or to comply with IAS. Audited accounts should be submitted to the agency within three months of the end of the calendar year. External

auditors are usually appointed annually and must be acceptable to the BMA. Additionally, the BMA has direct access to auditors in order to protect the financial integrity of a bank. Direct access by auditors to the BMA is allowed at the discretion of the auditors and inspection is carried out on a regular basis that can cover any aspect of banks' operations.

Regular meetings are held with senior management of banks to discuss past performance and future strategies. BMA maintains a close co-ordination with auditors in accordance with Bank for International Settlements (BIS) directives. Meetings are held with all locally incorporated banks in order to discuss critical issues, such as capital adequacy, asset quality, internal control, profitability and liquidity. Inspections are carried out related to management, control systems, accounting and other book keeping records. Money-changers provide the BMA with monthly turnover returns and quarterly P&L and balance sheet statements.

There is a licensing procedure for all banks, and the criteria are the same whether for an onshore or offshore license. The provisions of the law require that banks seek the prior approval of the BMA before merging or before acquiring an influential interest in any other entity. The law also restrains banks from investing in real estate. With the approval of the BMA, banks are free to invest in other financial business. Off-shore banking units (OBUs) are not allowed to deal with residents of Bahrain except for the government and fully licensed banks. They can also accept deposits from non-banks outside Bahrain (minimum US $50,000). They can only make loans and make advances to non-residents. Since November 1993, the provision of investment and other financial services, other than by a bank, has required a special license from the BMA.

Kuwait

The Central Bank of Kuwait (CBK) is empowered to regulate and supervise the country’s financial system. CBK’s basic authority comes from "Law 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organization of Banking Business". (Kabir, 2002) The representative of the Ministry of Finance on the Board of Directors may request the suspension of any resolution issued by the Board relating to Monetary and Credit Policy for referral to the Minster of Finance.

CBK can, at any time, inspect institutions that are under its supervision. Bank examination is performed on-site and off-site. The on-site inspections are performed on a regular basis at a bank’s head office and at selected branches. These inspections involve a

comprehensive examination of a bank's accounting and internal control procedures and systems. In addition to the full inspections, the CBK also conducts special visits that concentrate on a particular aspect of a bank's operations. The overall objective is to evaluate the financial conditions of a bank through the use of the CAMEL model.

The off-site visit focuses on both quantitative and qualitative factors. Supervision is conducted by analyzing monthly statistical returns. The information required includes portfolio exposure, volume of classified loans, large exposures to individual customers, liquidity profile, foreign exchange operations and projected balance sheets. Information provided remains confidential, but sector statistical data is published in consolidated form. CBK relies on the external auditors to supplement its supervisory duties. External auditors appointed by banks must be approved by CBK.

No banking institution is allowed to start operations until it has been registered in the Register of Banks at CBK. Registration or refusal of registration is decided by the Ministry of Finance on the recommendation of the CBK. Banking business may only be practiced by institutions set up in the form of public shareholding companies. According to "Law No. 32 of 1968," the capital of any bank shall not be less than KD3 million, although in practice the required level would be much higher. Since 1992, all Kuwait banks were required to achieve capital ratios in excess of 8% under the Capital Adequacy Directive set up by the Basle Committee. In April 1997, CBK raised the minimum requirement to 12%.

Mergers, acquisitions or participations in other banks require CBK approval. CBK's policy has not provided banks with incentives to merge but claims that it relies on the direction of the banks' shareholders to make such strategic decisions. Given the current ownership and strong capital ratios of the Kuwait banks, it is unlikely that mergers will occur in near future.

Banks must not engage in trade or industry, or own goods, unless such goods have been acquired in settlement of debts due to them. The bank must sell such goods within one year from the date of acquisition. Banks must not purchase any real estate, other than that required for conducting their business or accommodating their staff, unless such property has been acquired in settlement of debts. In the latter case, the bank must sell the real estate within a period not exceeding three years. Banks must not own or deal in their own shares, unless such shares have been acquired in settlement of debts due to them, provided that they sell them within two years from the date of acquisition. Banks may purchase shares of other commercial companies, not exceeding 50% of the bank's

own funds. Banks may also own shares or other assets held with them in settlement of debts due to them. In such cases the bank should dispose of these assets within two years from the date of acquisition.

Saudi Arabia

Banking in Saudi Arabia falls under the responsibility of The Saudi Arabian Monetary Agency (SAMA), formally established by Royal Decree in 1952. Its Charter was revised and its objectives clearly enumerated in a Royal Decree of 15 December 1957. The Banking Control Law (promulgated by a Royal Decree of 11 June 1966) defined the banking business in Saudi Arabia and who may conduct it, requirements for bank directors and management and the mechanism for the licensing of banks. Further, the law authorizes SAMA to

- review all applications for banking licenses and submit its recommendation to the Ministry of Finance,
- ensure compliance with the conditions of licenses and with the banking laws,
- charge penalties to banks which fail to meet requirements,
- place limits (both qualitative and quantitative) on banks' lending,
- set maximum bank fees and commissions,
- set minimum cash margins for banks' credits or guarantees,
- set minimum collateral ratios,
- establish and enforce minimum reserve requirements and minimum capital bases and ratios,
- require such reports or information from banks as it deems necessary, and
- conduct on-site inspections of a bank's books, either directly or through outside auditors (Kabir, 2002).

SAMA maintains tight control over the banking system and maintains strict supervision standards by means of quantitative and qualitative policy directives. Banks are required to submit numerous standardized returns to SAMA on a regular basis, which are used for both H-Statistical and supervisory purposes. Most of these returns deal with capital adequacy, liquidity, related-party lending and foreign exchange exposure. As authorized by law, SAMA examiners make periodic on-site inspections of banks, examining records, confirming compliance with laws and regulations and assessing the adequacy of banks' internal control systems. Furthermore, the agency maintains frequent formal and informal contact with banks' top management, which serves to

foster a culture of communication and co-operation between the central bank and the individual banks. The Banking Control Law requires that banks appoint two joint external auditors from a list of approved auditors. It is preferred that auditors be members of a professional organization in the U.K or in the U.S.A.

A bank’s annual accounts must include a certificate from management and must be countersigned by the auditors. Following the audit certification, the statements are sent to SAMA for approval. The financial statements, audit report and annual report by the banks’ management must be approved in general meetings, following which the annual report may be published and distributed. Furthermore, banks must file a copy of their final accounts with both SAMA and the Ministry of Commerce within six months of the year-end. Licensed money-changers must submit their annual statements to SAMA.

The Banking Control Law assigns SAMA the responsibility of reviewing license applications for the creation of new banks, the opening of new branches and the installation of off-site ATMs. SAMA then passes its recommendation on to the Ministry of Finance, which usually follows the agency’s recommendation. The minimum paid-up capital for a joint-stock bank is SAR ten million, but a much higher level of initial capital would most certainly be required before SAMA recommends issuance of a license. SAMA is also responsible for license renewals to money-changing institutions. Foreign banks (with the exceptions of the GCC countries) are not allowed to operate branches in the Kingdom since the early 1980s, when existing foreign bank branches were locally capitalized and converted to joint-venture banks with a minimum 60% Saudi ownership. Banks must obtain a license to open local or overseas branches, or to install off-site ATMs. A former regulation limiting banks to one foreign branch has been rescinded.

Without the approval of SAMA, banks cannot change the composition of their capital, undertake plans to merge with or acquire another bank, or cease their banking activities. The ownership of Saudi banks, as well as the sale or transfer of that ownership, falls under the responsibility of SAMA. Banks are precluded from acquiring, without the approval of SAMA, shares of any other local bank or shares in any other company established abroad.

Banks cannot engage in any trading activity and are prohibited from owning stocks of any other joint-stock companies incorporated in the Kingdom, in excess of 10% of the paid-up capital of such a company, which is limited to 20% of the bank's capital and reserves, which can, when necessary, be increased by the agency. An exception is

made for shares acquired in settlement of debt. Banks are not allowed to acquire or lease real estate for other than their banking purposes.

Oman

Commercial banks in Oman are regulated by the Banking Law of 1974 and the Banking Regulations of the Central Bank of Oman (CBO). The CBO is the banking supervisory authority. The Banking Law of 1974 gives the CBO full powers to control the activities of Oman's commercial banks and other financial institutions. The CBO’s supervisory procedures treat local and foreign banks similarly; however, a few regulations for foreign banks are slightly different from those for local banks. Banks are also required to follow the Commercial Companies Law of 1974, the Commercial Registration Law, the Oman Labor Law of 1973 and the Social Security Law of 1991. A new Banking Law in 2000 replaced the former banking Law. The prime purpose of the new law of 2000 is to catalyze development in the banking sector.

Banks must submit monthly and quarterly reports on returns to the CBO. These consist of balance sheets and other financial information, including foreign exchange position, lending ratios, loan sector analyses, asset quality reports and capital adequacy calculations. Banks are also required to submit annual audited reports on financial statements comprising a balance sheet, a statement of retained earnings and a profit and loss account. The formats for these statements are provided by the CBO and they have to be strictly followed. The central bank conducts on-site inspections of all banks at least once a year, and examiners produce detailed reports that identify instances of non-compliance or weaknesses in the bank's internal controls. If a bank fails to comply with official directives or policies or violates the provisions of the Banking Law, the CBO may withdraw its banking license, impose a penalty fee and deny the bank access to the CBO's credit facilities. A rating system has been set up for evaluating the performance of all banks.

All banks are obliged to be licensed by the CBO. An applicant for a banking license must submit names of its shareholders, individually holding 5% or more of subscribed capital, and information about its directors and senior management. The CBO may specify minimum professional qualifications for management appointees. All organizations engaged in money exchange business must register with the central bank and follow its licensing procedures. The regulation distinguishes between institutions engaged in both money exchange and draft issuance and those engaged only in money

exchange. The minimum paid-up capital for local banks is USD $26 million, and for foreign banks, USD $7.8 million. The approval of the CBO is required before a company or entity holding 10% or more of the voting shares. Total equity participation may not exceed 25% of a bank's net worth. All local banks are required to pay taxes.

Banks are not allowed to buy real estate for investment, nor may they lease their real estate properties without prior approval from the Central bank. Other than these two restrictions, commercial banks are permitted to engage in a wide range of banking activities. Banks have to obtain a special license from the CBO to enter into investment banking activities. Additionally, approvals are required from the Capital Markets Authority for engaging in activities that fall within the jurisdiction of the Muscat Securities Market (MSM). The CBO may ask a bank willing to undertake investment-banking activities to increase its net worth. Banks are required to maintain minimum ratios as set by the CBO. The CBO has granted investment-banking licenses to most commercial banks operating in the country. The banks can now offer project financing, brokerage, investment advisory, investment fund management, underwriting and trustee services. Branch licensing policies are designed to encourage the economic development of Oman's rural areas. There are no restrictions on opening branches outside the capital areas. At least 15% of deposits collected from any new branch must be lent at that branch during the first year of operation. This percentage increases in subsequent years.

3.4. Kuwait’s GATS Commitment and Liberalization

The progressive liberalization of trade has become a motive not only for developed economies but also for ‘developing’ economies alike. Institutionalizing this movement in the form of the World Trade Organization in 1995, following the eight-year Uruguay Round negotiations, systematized the ensuing trade liberalization process and established a forum for dialogue between and among the various signatory nations. The WTO became the breeding ground for more agreements that would aim to liberalize additional sectors of the respective signatory economies. (Jabsheh, 2001)

Services may be characterized with a number of salient characteristics, which make this sector more pliable and responsive to liberalization. Inherently, liberalization invites competition and FDI, foreign direct investment, which will subsequently modernize the entire business infrastructure and upgrade the quality of the indigenous service providers. Developing countries cannot afford to maintain inefficient sectors. Liberalization is one of the quickest ways to develop a sector without public

expenditure. Introducing a dose of foreign competition frees government and taxpayers from that burden (Jabsheh, 2001). In order for LDCs to participate and integrate effectively in the world community, their objectives should focus on external liberalization, combined with an active strategic plan to deregulate and privatize core infrastructural sectors.

Trade liberalization is always controversial; however, its long-term benefits to most parties involved are always rewarding. In a nutshell, trade stimulates economic growth, raises incomes and leads to a more efficient allocation and utilization of scarce resources. The basic argument of comparative advantage, competitive advantage and international division of labor is still the thrust behind trade liberalization at a very basic level. Empirical estimates of the impact of liberalization on growth, welfare and development have shown that open economies have grown on average approximately 2.5% faster than closed economies. (Jabsheh, 2001) For ‘developing’ countries, the figures are even more promising.

The GATS was one of the major outcomes of the Uruguay Round Agreements (URAs), based on the same principles as the previous GATT. The General Agreement on the Liberalization of Financial Services is part of the General Agreement for the Liberalization of Trade in Services, (GATS). The former has identified “financial services” carefully. The services agreement under the WTO, signed in 1995, did not effectively deal with this sector; therefore, a new set of rules were set forth in December, 1997 and implemented in March, 1999. Three sectors within “financial services” were greatly improved the stock market, insurance and banking. Based on these agreements, Kuwait has accepted up to 40% foreign ownership in its local banks.

All WTO signatories are also GATS members; however, they may differ in the levels of quantitative commitments within each service sector covered under the GATS. The GATS covers 160 sectors. There are 11 aggregate sectors identified on the ‘classification’ list. Tourism, for example, has drawn the highest number of ‘bindings’ by member, followed by business and financial services. Financial services include two broad categories of services: insurance and insurance related services, banking and other financial services. “Banking” includes all the traditional services provided by banks such as acceptance of deposits, lending of all types, payment and money transmission services as well as services related to trading in foreign exchange and securities, money broking, asset management, settlement and clearing services.

Under the current format of the GATS, few obligations apply to signatories, unless a sector and the associated modes of delivery are subject to ‘specific commitments’ in the schedule of the signatory or the member. The main general obligations of the agreement are the MFN or the Most Favored Nation principle (II) and the transparency principle (article III). The GATS’ main provisions are the recognition of qualifications (article VII), monopolies and exclusive suppliers (article VIII) and business practices (article IX). The central ‘Specific Commitments’ are with respect to market access and national treatment. Market access (article XVI) provides a negative list of obstacles and barriers to trade those signatories should refrain from engaging in. Examples include imposing limitations on the number of suppliers, limitations on the participation of foreign capital, limitations on the total number of service operations or on the total quantity of service output, limitations on the total number of natural persons that may be employed, limitations on the total value of service transactions or assets and measures which restrict or require specific types of legal entity or joint ventures. The national treatment provision in the GATS (specified in article XVII) specifies that members should treat foreign countries’ products and services as they would treat their own, without imposing tariff and non-tariff barriers, unless there are special exceptions and arrangements made to suggest the contrary. (WTO Official Reports)

Kuwait is one of the moderate members in the GATS; along with Brazil, Colombia, Israel, Morocco, Nicaragua, Philippines and Romania, it is committed to 41-15 commitments. Trade in services is mandated under article XIX (19) of the GATS. The GATS is considered a landmark agreement. It applies to all services, except those that are non-commercial and government-related; for example, activities of central banks, social security authorities and monetary authorities.

The GATS ‘Annex on Financial Services’ provides specific provisions, with respect to domestic regulation and recognition arrangements. The Understanding on Commitments in Financial Services states that, “members shall endeavor to remove or limit any significant adverse effects of non-discriminatory measures on the financial service suppliers of any other member." (Ibid)

Associated with the GATS are protocols, which deal with results of subsequent negotiations, two of which pertain to the liberalization of financial services. The second protocol, “financial services,” was adopted in July 21, 1995, and entered into force in September, 1996 and the fifth protocol, was adopted in November, 1997 and was enforced in March, 1999. The GATS was developed to improve trade and investment

conditions, “through continuous multilateral negotiations amongst members." (WTO official Reports) It categorizes the supply of services into four main groups: cross-border supply, consumption abroad, commercial presence and presence of natural persons. “GATS is a powerful integrating mechanism. No government is obliged to liberalize, or make commitments on infrastructural services like finance and telecommunications. But the efficiency gains for these countries which do so make the cost of protecting inefficient services very high because GATS is about investment and technology transfer, among other things, and market access commitments are a powerful attraction for foreign direct investment (FDI).” The whole concept behind developing countries’ participation in a multilateral trading system is to encourage capacity building. Liberalization had to be closely tied to foreign investment because LDCs have shown a particular interest in investment-induced policies and in incentive mechanisms that attract them. Making the GATS investment-friendly served to enhance LDCs' trade in services.

One of GATS central principles is the concept of “progressive liberalization," knowing very well that liberalization is a continuous, gradual process, where countries are at different stages, in addition to the fact that it is a process foreign to many LDCs that are historically trained to upkeep large public sectors. Liberalization in the service sector is particularly important for developing countries, considering the fact that trade in services has grown faster than trade in goods over the past decade.

Services may be characterized with a number of salient characteristics. Services are: intangible, invisible, difficult to measure, constraints related to data exist particularly in the services sectors, simultaneously produced and consumed and not easily identifiable. The mere question of what represents a unit of production may spur a debate. Numerous market access obstacles on trade in financial services have been relaxed or removed during GATS continuous unilateral and multilateral negotiations. Though trade restrictions in financial services have been reduced, greater strides in this field will be achieved only if domestic regulations in the various member countries are improved.

Financial liberalization is most appreciated from the perspective of its absolute antagonist, financial repression. Financial repression is characterized mainly by regulated fixed rates of interest on loans and deposits, restraint of capital flows in and out of the country, deliberate disfavor toward foreign financial competitors, controlling the exit of financial mediators from the market and non-competitively soliciting work

for the banking sector through insurance programs that are financed by the government sector.

The objectives of liberalization are to increase the levels of competitiveness in the financial sector by opening the door to entrants, increasing and upgrading the available financial tools and options for investors and depositors by expanding the financial infrastructure of the sector, improving the process of determining and deriving interest rates, so that these rates reflect actual costs of financial resources, improving foreign exchange distribution, so that real costs are reflected and improving the packaging and customization of financial resources. Banks may be affected by liberalization in the following ways: profitability, development and market share, pricing policy, levels of risk and the quantity and quality of financial services. Other symptoms that may accompany liberalization include large increases in interest rates, under-capitalization, a noticeable increase in the level of risk and a rapid deterioration in the quality of loan packages. Inevitably, those banks that are unable to stay abreast will have to declare bankruptcy. History has shown that the road to liberalization is bumpy; it goes through phases, the first of which is a critical transient stage of transformation. This is the phase where most financial crises occur if they are going to happen. There are many examples around the world where this has occurred: In Mexico, 1996, a crisis that cost over the long-run almost 15% of that country’s GNP. Brazil and Venezuela also underwent similar experiences in 1996. In all three cases, financial crises occurred following intensive liberalization to the banking sector. Some of the reasons for the onset of a financial crisis include: excessive lending activity before liberalization, lack of information available to investors about banking principles, legal and corporate restraints that weaken banks’ positions and the occurrence of financial turbulence outside the banking sector, which reduces investors’ confidence in the local banks and results in capital flight, which in turn reduces the banks’ liquidity. A number of tools and indicators are available to predict whether a specific banking institution can survive post-liberalization. Closely monitoring banks at the outset of liberalization alerts decision-makers to early warning signals, setting an administrative or a managerial mechanism to identify institutions that are most susceptible to troubleshoot. These tools should be used effectively to aid in abating a crisis.

3.5. The Anticipated Policy in Kuwait

Banks operate in a highly competitive environment encouraged by the developments of new markets, instruments and techniques. Although many of these changes provide the means of diversifying risks, they also allow greater risks to be taken. These developments provide challenges to central banks in attaining the appropriate balance between and stability in the financial system.

One of the main responsibilities of a central bank is to prevent financial system instabilities. When financial situations, circumstances and pressures arise, central banks have the responsibility and the authority to contain what could eventually surmount into a financial crisis and intervene. If ‘preventive supervision’ is seen to be ineffective, central banks may act as, ‘lenders of last resort’. “This should never be seen as an automatic facility available to all banks in distress, but should be used only when the failure of a bank would pose a serious threat to the financial system as a whole.” (Marcus, 2000) The primary aim of the lender of last resort is therefore, not to save banks in distress, but rather to adopt a holistic paternal perspective that considers the effect that the failure might have on the system and what should be done to protect the system from contagion.

It is the central bank’s responsibility to provide a financial system in which the users of financial services can benefit from healthy competition between financial institutions, but also to ensure public confidence in the monetary system as a whole, without overstepping their boundaries of control and authority. From the perspective of a central banker whose main concern would be the avoidance of a banking and financial crisis; the increased diversification of banks’ loan portfolios may lower the probability of a banking crisis in the future. Diversifying location also spreads risk and hence equalizes because loans may perform poorly in one place and not in another market.

3.6. Conclusion

Restructuring the banking industry represents a challenge for bankers and for regulators. Besides strengthening supervisory arrangements, it is up to regulators to support the wave of restructuring by continuing to level the playing field in the banking industry and by eliminating any competitive distortions. This condition needs to be met for restructuring to have its full effect in terms of economic efficiency and proper resource allocation.

Mergers and acquisitions are successful when they are part of a strategy aimed at striking a balance between the need to strengthen existing product lines or diversification of activity, as part of medium term plans aiming at extensively reorganizing both distribution channels and means of production.

It is currently very difficult to predict which new technologies in financial services will be cost effective for banks and widely accepted by the public. Banks are exploring many different new ideas, and which of these will come to dominate the industry is far from clear. So in the final analysis, this is all highly speculative.

Some of the challenges that may face hopeful mergers in the GCC include the fact that shareholders are not unified, and that management is not motivated, in spite of the rationality of the decision. Changes in financial markets have had a significant effect on the way banks do business. To allow banks to compete and keep pace with these changes, the CMA needs to develop and implement a plan for regulatory reform that is flexible and adaptable to both past and future changes in financial markets. In recent years, the CMA of GCC countries have made many regulatory changes in order to achieve certain economic and social goals. The CMA of Bahrain, Kuwait, Saudi Arabia and Oman have strengthened the prudential norms in recent years. Asset classification and provisioning charges have moved closer to international standards. Banks are required to maintain capital to risk weighted assets ratios of 8% required by the BIS. Commercial banks use IAS. Overall, the CMA in these countries are very active in terms of supervising and monitoring their regulations on banking sectors. However, unlike the developed countries, they have occurred in a slow process. One of the major obstacles to achieving consensus on a plan for reform is that the authorities of the GCC countries often lose sight of common goals. GCC countries capture about 13% of the total assets of IBs in the world and are mainly concentrated in Bahrain, Kuwait and in the UAE. Recent studies show that the prudential regulations for IBs should have at least three objectives: systematic stability, an adequate level of compliance to Sharia rules and international acceptance to the Islamic banking operations. Most principles of effective banking supervision by the Basle Committee are relevant to the best practices of Islamic banking supervision, with operational differences. Some religious restrictions impact on the nature of the business. The strategic design for Islamic banking should cover at least two major objectives. First, the regulations should ensure the soundness of the Islamic banking operations. Second, the regulations should provide incentives to the system, so that they would naturally move back to its perfect paradigm. In a global

financial market, Islamic-banking regulators that operate IBs should think about the compatibility of the regulatory setting. Through a deep understanding of the nature of the Islamic banking business and the recent western banking supervisory framework, Islamic banking regulators will be able to develop a sound banking system without loosing its own distinction.

Part 4

The Banking Sector in Kuwait

4.1. Overview of the Kuwaiti Banking Sector

The banking sector in Kuwait has experienced moderate developments throughout the 1990's. In the earlier periods, state policies had generally directed substantial resources toward sustaining existing manufacturing and trading activities, and maintaining living standards by providing explicit and implicit subsidies to enterprises and households. Sound government financial support had been provided to the banking sector to overcome several crises, namely: the crash of "Souk Al-Manakh" in 1982 and the difficult debt problems caused by the Iraqi invasion. In addition, protection from foreign competition has also been provided. Foreign banks are not allowed to own financial institutions or operate in the local financial market. Since the primary role of the banking system was to channel funds to the real sector, efficiency and performance were not prioritized in this heavily supported and protected sector.

During the past number of years, the banking sector in Kuwait has experienced notable regulatory and technological changes. Advanced applications in computer and communications technology together with the introduction of new financial instruments, have altered the way banking is conducted. In this regard, one of the pivotal questions has been surrounding the effects of these changes on the efficiency and performance of Kuwaiti banks.

During the past three decades, many developed, developing and transition economies have undertaken extensive reforms of their banking systems. These reforms have included such measures as the liberation of interest rates, the removal of quantitative controls on lending, lifting barriers to competition, the privatization of government owned financial institutions and the introduction of new market-based financial services. The principal aim of these reforms has generally been to raise both the level of investment and the efficiency of resource allocation, and to enhance the provision of a wider range of financial services to all the sectors of the economy. The presence of a sound and efficient financial system is a vital prerequisite for effective savings and investment activities and thus economic growth. It is the vehicle by which a country's most profitable and efficient projects are systematically and continuously funded. Banking related research

will always stress the role of financial institutions in economic growth. Goldsmith (1969), and McKinnon (1973) provide conceptual descriptions and empirical examples of how the financial system affects the process of economic growth. Building on these seminal contributions, Bhattacharyay (1988, 1993), Gelb (1989), Ghani (1992), King and Levine (1993), Choudhuri et.al (1995), De Gregorio & Guidotti (1995), Hassan (1995), and Islam (1995) show that measures of banking development are strongly correlated with economic growth in a broad cross-section of countries. According to this view of research, a well-functioning financial system is critical for sustained economic growth.

On the basis of data from 35 countries between 1860 and 1963, Goldsmith (1969) concludes that, "a rough parallelism can be observed between economics and financial development if periods of several decades are considered". In an important paper, King and Levine (1993) investigated the causality problem following a post hoc, ergo proper hoc approach. They show that the predetermined components of financial development are a good predictor of growth over the next ten to 30 years. Thus banks are the most dominant financial players in any country. The role of the government is to ensure that financial institutions serve these vital functions efficiently. This role of the government is being performed by the central bank's regulatory and supervisory functions in order to enhance the solvency and the stability of the banking sector.

Since the 1970s developing countries have been undertaking various reforms in their financial sectors, including the Arab Gulf Cooperation Council (GCC) countries which have started to do this recently as part of their overall program of economic stabilization and growth. An empirical study, carried out by Bhattacharya (1988,1993) showed that all GCC countries except for Bahrain and Kuwait started the 1980s with low financial deepening. As economic activity picked up and banking habits developed, this ratio rose substantially in all of the GCC countries over the last decade. Moreover, there is an increasing move toward privatization in this region where GCC banks have a great opportunity. Banks could play an important role in their countries' economic development by facilitating, supporting and promoting private sector activities. In most of the GCC countries, bank shares are considered to be the most attractive investment opportunities, and bank shares account for a large portion of the stock markets' capitalization. There is a growing need for a well-developed Gulf financial market to attract domestic funds currently invested outside, and to direct them to regional private sector investments. For the banking sector, this presents real challenges.

Two main approaches have been used to evaluate the performance of a banking sector. The first is the macroeconomic approach, which concentrates on macro-variables, such as real growth, saving and investment, and interest rates. The main shortcoming of this approach lies in the difficulty in isolating the effects of financial variables from those of other variables (institutional or macroeconomic developments).

The second approach concentrates on analyzing the financial sector in general, and on determining the changes in the structure and performance of the sector in particular. Attempts have been made to estimate changes in such variables as the cost, revenue, and profitability of the financial institutions operating under the same regulatory conditions, [Hardy and di Patti (2001), Grabowski, Rangan and Rezyanian (1994), Berger and Mester (1997) and Humphry and Pully (1997)]. The data set needed to define costs, revenues and profits can be obtained from the annual information on the main balance sheet elements and revenue and expense items of the financial institutions.

To identify and compare the relative performance of banks operating in a country, we first need to examine each bank's balance sheet, which lists sources of bank funds (liabilities) and uses to which these resources are put (assets). Banks obtain funds by borrowing and by issuing other liabilities, such as deposits. They then use these funds to acquire assets such as securities and loans. Revenues come from interest on loans and securities and fees receipts. When the revenue of a bank exceeds the expenses of issuing liabilities, a profit is made. A general structure of a balance sheet of a commercial bank appears in Table 4.1. The balance sheet is an appropriate source of bank activity.

Table 4.1. A General Structure of a Commercial Bank's Balance Sheet

Assets (Uses of Funds)	Liabilities (Sources of Funds)
(In order of decreasing liquidity)	Checkable deposits
Reserves	Nontransaction deposits
Cash items in process of collection	Savings deposits
Deposits with other banks	Small denomination Time deposits
Securities	Large denomination Time deposits
U.S. government and agency	Borrowings
State and local government and other Securities	Bank Capital
Loans	
Commercial and industrial	
Real Estate	
Consumer	
Interbank	
Other loans	
Other Assets	
(For example, physical capital)	

For the purpose of studying bank productivity, it is possible to define bank's inputs and output in terms of its balance sheet entries and revenue and expense items. For example, deposits and loans to the banks are inputs, while the bank's lending activities are considered to be outputs. There are many approaches to investigate bank production. However, the asset approach, the user-cost approach, and the value-added approach are most commonly used.

It is important to point out that different banking measures on one activity or more may have unintended, and often adverse, effects on operational performance and technology improvements of banking operations. For example, increasing reserve requirements would reduce banks' lending capability and limit profitability. It is therefore essential for policymakers and bank management to identify the appropriate monetary and financial instruments that would lead to the desired efforts in productivity and performance with the least possible cost.

It is the purpose of this task to overview the existing conditions of the banking sector in Kuwait. The following is a structure of the task's framework and the issues that it will address:

- Evaluation of the current status of the Kuwaiti Banking sector.
- Analysis and evaluation of the financial and banking indicators of the Kuwaiti banking sector.
- The current competitiveness of the banking sector in Kuwait.
- Competitiveness of the Kuwaiti banking sector within the GCC.
- Is merging an option or a necessity in the case of the Kuwaiti Banking Sector?

The major objectives of this part of the study are specifically:

- To review the structures & characteristics of the banking sector of Kuwait;
- To examine the growth & trends of Kuwaiti banks;
- To examine the performance of Kuwaiti banks;
- To investigate banking regulations and supervision of Kuwaiti banks;
- To provide the ratings of these banks, and
- To examine the challenges and the opportunities of Kuwaiti banks

4.2. Importance of and the Framework for Evaluating Bank Performance

The evaluation of bank performance is a complex process involving interactions between the environment, internal operations as well as external activities. Following, are the major factors used for evaluating bank performance**:**

- Bank shareholders are directly affected by bank performance
- Bank management is evaluated on the basis of the bank's historical performance and its performance vis-à-vis other banks.
- Regulators are concerned about the safety and soundness of the banking system and the preservation of public confidence by providing what is in effect, an "early warning system".
- Depositors are interested in how well the bank is doing.
- The business community and the general public should be concerned about their banks' safety and soundness because economic prosperity is eventually linked to the success of a bank.

4.2.1. A Framework for Evaluating Bank Performance:

Like any business entity, the ultimate measure of a bank's performance is the value of its common stocks. Maximization of shareholders wealth involves internal as well as external management factors as shown in figure 1.

Financial data on commercial banks are presented in two basic documents: the ***balance sheet*** and the ***income statement***. Following are the important items of bank Financial Statements**:**

- Reserves for loan losses
- Earnings assets
- Interest-bearing liabilities
- Interest-sensitive assets/liabilities
- Interest sensitivity gap
- Liquidity
- Net charge-offs
- Net interest margin
- Non-performing assets
- Provision for loan losses
- Return on assets
- Return on equity

In order to evaluate the internal performance of a bank, financial ratios are constructed by forming ratios of accounting data contained in the bank's balance sheet and income statements. A wide variety of financial ratios can be calculated to assess different characteristics of financial performance. To evaluate a particular financial ratio for a bank, comparisons with peer group banks are used. In addition, ratio trends over time provide valuable information about the bank's performance. External performance is best measured by evaluating the bank's market share, regulatory compliance, and public confidence. Data are collected from the publications of the Central Banks of the GCC countries and the Capital Intelligence (CI) CD-Rom database. Additional information is collected from the various ministries and then results are discussed and reported in various tables and charts.

4.3. The Case of the Kuwaiti Banking Sector

4.3.1. Evaluation of the Current Status of the Kuwaiti Banking Sector

As discussed in the previous progress report of the same project, there are six commercial banks in Kuwait: National Bank of Kuwait, Gulf Bank, Al-Ahli Bank, Burgan Bank, Commercial Bank of Kuwait, and The Bank of Kuwait and the Middle East. In addition there are two specialized banks: The Industrial Bank and the Real Estate Bank. Moreover, the Credit and Saving Bank is a specialized Government bank, and Kuwait Finance House provides financial services according to Islamic principles and Shariaa.

Many forces in Kuwait have pressured the government into becoming involved in shaping and regulating the banking system. The Kuwaiti Government has always:

1. Intervened to assist banks during crises, such as Souk Al-Manakh crises in 1982 and the difficult debt problem in 1991.
2. Restricted ownership of banks to nationals, except for one bank (branch of Bahrain & Kuwait Bank), which is owned by Kuwaiti and Bahraini interests on a 50/50 basis. It is important to note that foreign operations of Kuwaiti banks constitute a substantial part of their activities.
3. Ensured the soundness of banks and the safety of deposits.

The institutional structure of the banking and financial sector is under the supervision of the Central Bank of Kuwait (CBK). Developments in this sector have been stimulated by rapid expansion in the Kuwaiti economy, particularly following gains in oil receipts since late 1973, remarkable growth in the GNP and population, the construction of the infrastructure, and the consequent increase in demand on banking services. There has been a tendency on the part of banking and financial authorities to develop this sector as an alternative to lessen the degree of dependency on oil revenues and as a means to diversify the source of income. The reflections and effects of these developments on the banking sector may be summarized in the following up-to-date (2001) characteristics:

- All six commercial banks are privately owned (National Bank of Kuwait, Gulf Bank, Al-Ahli Bank, Burgan Bank, Commercial Bank of Kuwait, and The Bank of Kuwait and the Middle East).
- There are two specialized banks owned by the private and mixed sectors, which finance certain sectors, namely The Industrial Bank and the Real Estate Bank. In

addition, the government is the sole owner of Credit & Saving Bank, which provides real estate loans to Kuwaiti nationals.

Table 4.2. Major Financial Indicators of Kuwaiti Banks (Amount in Million KD; Year 2001)

Banks	Return on Assets (ROA)	Return on Equity (ROE)	Equity to Assets	Assets	Loans	Net Profit	Liquid Assets Ratio* (LAR)	Liquid Deposits Ratio* (LDR)
Commercial Banks	1.78%	14.03%	12.85%	11,792	4,968	232.5	9.56%	27.27%
Specialized Banks	1.97%	8.38%	24.53%	1,102	507	19.7	23.25%	14.28%
All Kuwaiti Banks**	1.88%	11.21%	18.69%	12,894	5,475	252.2	16.41%	20.78%

***** Liquidity Category (I + II + III)

****** Excluding Kuwait Finance House

Source: Prepared from Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait.

- At the end of 2001, local branches of the following commercial and specialized banks, Kuwait Finance House, Bank of Bahrain & Kuwait, reached 164 branches, excluding head offices (CBK, 2001).
- Available data indicate that the total balance sheet of the six Kuwaiti commercial banks (National Bank of Kuwait Gulf Bank, Al-Ahli Bank, Burgan Bank, Commercial Bank of Kuwait, and The Bank of Kuwait and the Middle East) reached KD 11792 million by the end of 2001 (Table 4.2). Comparing this figure with that of the year 2000 (KD 10611 million) shows a substantial growth of about 11%. This growth was driven by many factors such as: (1) The improved performance of the domestic economy; (2) The payment of compensation for damages caused by the brutal Iraqi invasion and (3) The rebounding of the Kuwaiti Stock Exchange.

– Table 4.2 contains some other aggregate financial indicators for all Kuwaiti Banks (excluding Kuwait Finance House) at the end of the year 2001. Return on assets and equity was 1.88% and 11.21% respectively. The liquid asset ratio was 16.41% and liquid deposit ratio was 20.78%.

The following section provides a detailed picture of the existing condition of the banking sector by analyzing and evaluating the relative financial position for each of the addressed six commercial banks.

4.4. Analysis and Evaluation of the Financial and Banking Indicators of the Kuwaiti Banks

4.4.1. Preview

It is required from each Kuwaiti commercial bank to file quarterly and annual reports periodically which describe the banks assets and liabilities, income and dividends, ownership, foreign exchange operations, and so on. These banks are subjected to periodic examination to ascertain the banks' financial condition.

There are many financial indicators, which when examined, can help in evaluating the absolute and the relative position of each bank. Such indicators include: assets size, rate of return on assets, return on equity, equity to assets ratio, size of loans, bank's liquidity, and net profits.

The following is a brief presentation of each of the above-mentioned indicators for each of the six Kuwaiti commercial banks.

4.4.2. Assets

The assets of a bank constitute the uses of bank funds. The income-earning assets, which yield interest payments, enable banks to make profits.

Reserves, cash, securities, loans to others, and physical capital are common items in each Kuwaiti commercial bank's assets. The absolute and relative size of each of these items reflects, in some way, the financial position of the bank. The aggregate size of total assets, at one point in time, reflects the wealth of the bank domestically and within a group of banks.

Table 4.3. and Figure 4.1. show the assets position and ranking for Kuwaiti commercial banks. The table shows that between 1998 and 1999, total assets for all Kuwaiti banks experienced a slight decrease from KD 10263 million to 10159, which

means about 1.1 % decrease. Many economic factors had to do with this decrease, such as low oil prices, the sharp decline in equity prices, and the general economic slowdown. However , between 1999 and 2001, assets value started to increase from KD 10159 million (for all Kuwaiti commercial banks) in 1999 to KD 11792 million in 2001, i.e. an increase of KD 1633 million (16.07%). Noticeable in this regard is the continuity of the same ranking, according to assets size, for the six commercial banks between 1998 and 2001. The National Bank of Kuwait has always captured the first place with assets share between 37.4% and 38.6% of total assets value of all six banks. The second largest assets value has always belonged to Gulf Bank (about 16%).

These figures reflect a noteworthy size of a differential case.

Table 4.3. Kuwaiti Commercial Banks Ranking By Assets (1998-2001)
(Amount in Million KD)

Banks	1998		1999		2000		2001	
	Rank	AMT.	Rank	AMT.	Rank	AMT.	Rank	AMT
National Bank of Kuwait	1	3835	1	3797	1	4093	1	4470
Gulf Bank	2	1839	2	1777	2	1653	2	1878
Commercial Bank of Kuwait	3	1364	3	1378	3	1544	3	1691
Al-Ahli Bank of Kuwait	4	1163	4	1161	4	1152	4	1487
Burgan Bank	5	1119	5	1149	5	1137	5	1185
BKME	6	943	6	897	6	1032	6	1081
Total for All Commercial Banks		10263		10159		10611		11792

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

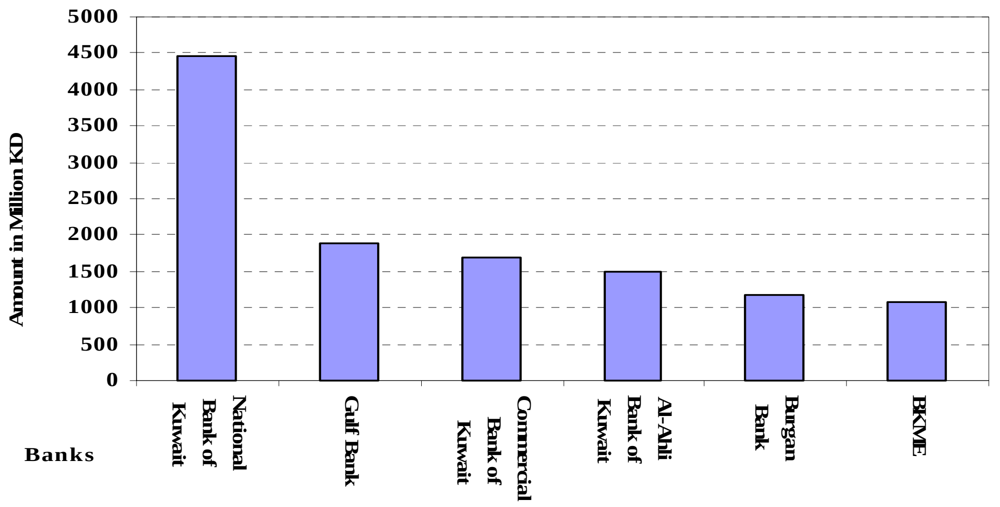


Figure 4.1. Kuwaiti Commercial Banks Ranking By Assests (2001)

The structure of the aggregate balance sheet of local banks at the end of year 2001 indicates that assets had been dominated by three items, namely: claims on the private sector, claims on the government and foreign assets. The collective share of these items in total assets reached 81.5% at the end of 2001 (Central Bank of Kuwait, 2001).

4.4.3. Bank's Return and Net Profit

Any commercial bank manages its assets so that it earns the highest possible return. The bank manager always has three primary concerns: Firstly, to make sure that the bank has enough ready cash to pay its depositors when there are deposit outflows. Hence, the bank must acquire sufficient liquid assets to meet the obligations of the bank to depositors. Secondly, to minimize risk by acquiring assets that have a low rate of default risk and by diversifying asset holdings. Thirdly, to acquire funds at low cost. Therefore, the rate of return on assets reflects the extent to which bank management is successful in managing the bank's assets.

Table 4.4. and figure 4.2. give an overall picture of the performance of the Kuwaiti commercial banks in terms of their return on assets between 1998 and 2001. The table shows that the National Bank of Kuwait (NBK) and Gulf Bank (GB) have always been on top of the list by an average rate of return on assets of 2.33% for NBK and 1.9% for GB during the 1998-2001 period. The other four commercial banks exchanged places from year to year. Worth noting in this regard is that three of these four banks, namely: BKME, Burgan Bank and Al-Ahli Bank, had a rate of return on assets which was always below average for all banks. The figures of 2001 are much closer than those of the previous years with less variation between banks on the one hand, and between each bank and the average rate for all banks, on the other.

Table 4.4. Kuwaiti Commercial Banks Ranking According to Return on Assets (1998-2001)

Banks	1998		1999		2000		2001	
	Rank	%	Rank	%	Rank	%	Rank	%
National Bank of Kuwait	1	2.05	1	2.46	1	2.45	1	2.35
Gulf Bank	2	1.60	2	1.65	2	2.14	2	2.24
Commercial Bank of Kuwait	5	0.80	3	1.46	3	1.94	3	2.07
BKME	3	1.09	4	1.34	5	1.38	4	1.45
Burgan Bank	4	0.91	6	0.29	4	1.76	5	1.39
Al-Ahli Bank of Kuwait	6	0.45	5	0.88	6	0.89	6	1.18
Average for All Commercial Banks		1.15		1.35		1.76		1.78

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

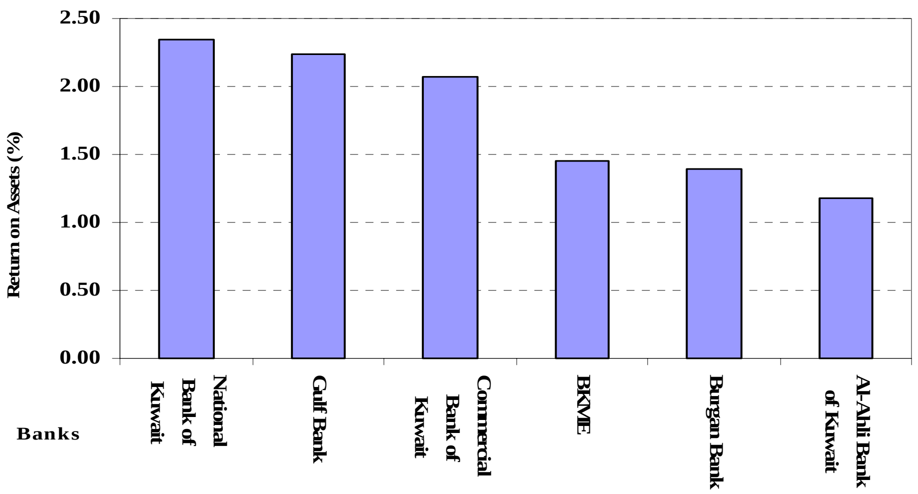


Figure 4.2. Kuwaiti Commercial Banks Ranking According to Return on Assets (2001)

Assets generate revenues for banks, while liabilities require payments (cost). Net profit is the outcome or the difference between bank's total revenue and total cost. Therefore, ratios of net profit to: total assets; total shareholder's equity and; total paid up capital are good indicators of the efficiency of local banks in utilizing financial resources to enhance their reserves on the one hand, and to improve net profit ratios, on the other.

The following table 4.5. includes net profit ratios for local banks during the (1997-2001) period (The Central Bank of Kuwait, 2001).

Table 4.5. Net Profit Ratios for Local Banks* (1997 – 2001)

Ratio (%)	**1997**	**1998**	**1999**	**2000**	**2001**
Net Profit to Total Assets	1.7	1.6	1.8	2.0	2.0
Net Profit to Shareholders Equity	15.7	13.8	15.3	17.6	18.2
Net Profit to Total Paid-up Capital	33.5	29.9	33.4	40.1	43.3

* Local banks considered by CBK are: commercial, specialized and the Kuwaiti Finance House.

Source: CBK Economic Report, 2001.

During 2001, commercial banks continued to realize improved profit levels, which reached KD 232.5 million, compared to KD 210.3 million, KD 168.4 million and KD 144.7 million for the years 2000, 1999, and 1998 respectively (Table 4.6 and figure 4.3). These numbers mean a 61% increase in total net profit for the six commercial banks between 1998 and 2001.

Table 4.6. Kuwaiti Commercial Banks Ranking By Net Profit (1998-2001)
(Amount in Million KD)

Banks	1998		1999		2000		2001	
	Rank	AMT.	Rank	AMT.	Rank	AMT.	Rank	AMT.
National Bank of Kuwait	1	78.7	1	93.3	1	100.4	1	105.0
Gulf Bank	2	29.4	2	29.4	2	35.5	2	42.1
Commercial Bank of Kuwait	3	10.9	3	20.1	3	30.0	3	35.0
Burgan Bank	5	10.2	6	3.3	4	20.0	4	20.7
BKME	4	10.3	4	12.1	5	14.2	5	15.7
Al-Ahli Bank of Kuwait	6	5.2	5	10.2	6	10.2	6	14.0
Total for All Commercial Banks		144.7		168.4		210.3		232.5

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

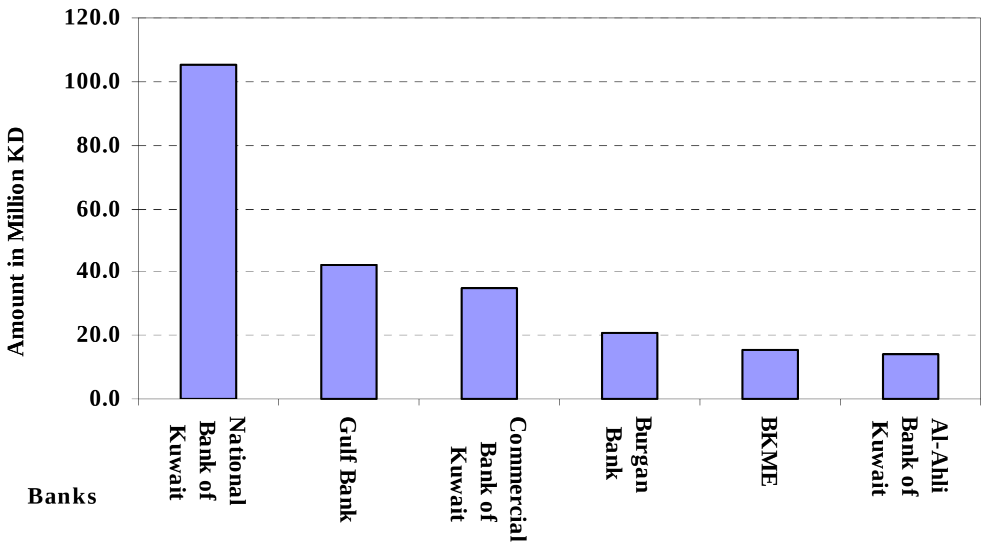


Figure 4.3. Kuwaiti Commercial Banks Ranking By Net Profit (2001)

Table 4.6. also illustrates changes in net profit for Kuwaiti commercial banks during the (1998-2001) period. An interesting feature of the net profit structure during that period is the continuation of the same bank rating in all four years. Moreover, the National Bank of Kuwait had always possessed the highest share, which ranged between 45% (2001) and 55% (1999), or about half of the total net profit for all six Kuwaiti commercial banks.

The picture does not change much when reviewing and comparing return on equity ratios. The ranking is almost the same with National Bank of Kuwait on the top, accompanied with minor exchange positions during 1998 and 1999 (Table 4.7. and figure 4.4.).

Table 4.7. Kuwaiti Commercial Banks Ranking According to Return on Equity (1998-2001)

Banks	1998		1999		2000		2001	
	Rank	%	Rank	%	Rank	%	Rank	%
National Bank of Kuwait	1	17.57	1	19.68	1	20.17	1	20.08
Gulf Bank	2	14.52	3	11.21	2	17.01	2	17.85
Commercial Bank of Kuwait	4	6.91	6	2.13	3	14.74	3	15.42
Burgan Bank	5	6.81	2	11.39	4	13.19	4	11.48
BKME	3	13.92	4	9.05	5	10.15	5	10.50
Al-Ahli Bank of Kuwait	6	3.92	5	7.06	6	6.97	6	8.82
Average for All Commercial Banks		10.61		10.09		13.71		14.03

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

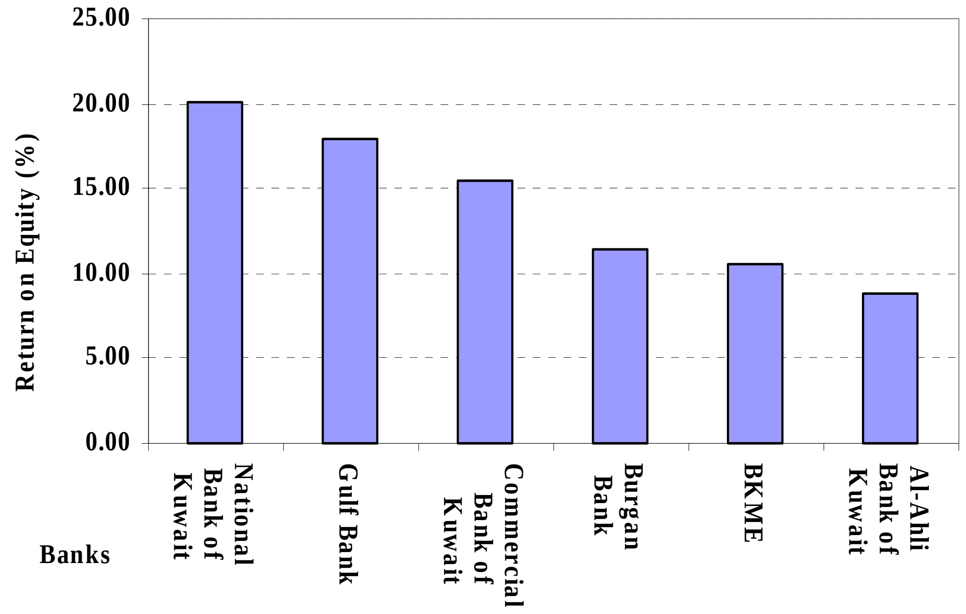


Figure 4.4. Kuwaiti Commercial Banks Ranking According to Return on Equity (2001)

4.4.4. Shareholders' Equity

The market value of the shareholders' equity plus accumulated reserves on the liabilities side of the balance sheet represents bank's capital, the bank's net wealth, which measures the extent of protection provided against any future risks faced by one or more of the elements of assets, such as loan loss. For example, banks' capital provides a cushion to absorb loan loss when it occurs.

For all six Kuwaiti commercial banks, the average of equity to assets ratio increased slightly from 12.11% in 1998 to 12.93% in both 1999 and 2000. A very slight change occurred in 2001, as the ratio declined by 0.08% to become 12.85% (table 4.8. and figure 4.5.).

Table 4.8 indicates that the equity to assets ratio for individual commercial banks ranged between 11.02% (Burgan Bank, 1998) and 14.86 (BKME, 2000). Also worth noting is the fact that there is a Capital Adequacy Standard, "Solvency", which has been defined according to "Basle Committee" recommendations and the agreement among the Gulf Cooperation Council (GCC) countries to apply a unified standard for measuring capital adequacy for banks in member countries. The Central Bank of Kuwait applied a ratio of 8% as the standard minimum requirement for the ratio of broad capital to assets. This ratio was applied from the end of 1992 until the end of

1996, and then a 12% ratio has been applied since the end of 1997 (Central Bank of Kuwait, 2001). Available aggregate data published by the Central Bank of Kuwait show that the capital adequacy ratio for each of the Kuwaiti commercial banks is substantially higher than the required minimum ratio. The average of this ratio for all local banks (commercial and specialized) subject to the supervision of the CBK, reached 22% at the end of the year 2001 (CBK, 2001).

Table 4.8. Kuwaiti Commercial Banks Ranking According to Equity to Assets (1998-2001)

Banks	1998		1999		2000		2001	
	Rank	%	Rank	%	Rank	%	Rank	%
BKME	2	13.39	1	14.86	1	13.56	1	13.85
Commercial Bank of Kuwait	1	13.43	3	13.00	3	13.19	2	13.44
Al-Ahli Bank of Kuwait	4	11.62	5	12.40	4	12.72	3	13.42
Gulf Bank	5	11.51	6	11.44	5	12.60	4	12.57
Burgan Bank	6	11.02	2	13.37	2	13.35	5	12.11
National Bank of Kuwait	3	11.67	4	12.49	6	12.16	6	11.70
Average for All Commercial Banks		12.11		12.93		12.93		12.85

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

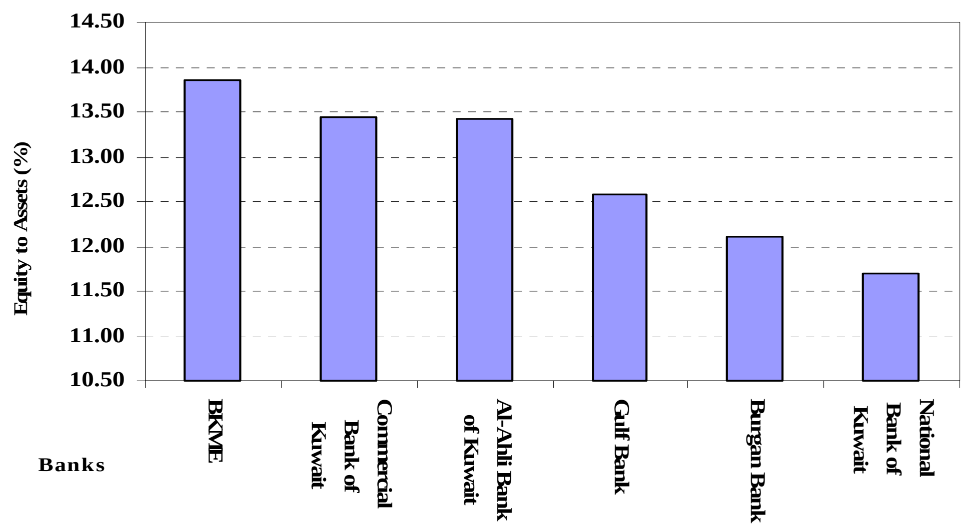


Figure 4.5. Kuwaiti Commercial Banks Ranking According to Equity to Assets (2001)

4.4.5. Liquidity Ratios

Liquid assets include: cash money (currency) that is physically held by banks, readily available bank balances, such as demand deposits at other banks or current account balances, other short term deposits, treasury bills and other assets that can be quickly converted into cash. These are further classified as follows (Financial Operating Report, 2001):

- Liquid assets - Category 1: This includes cash in hand, current accounts with banks, and balances with the central bank.
- Liquid assets - Category 2: This includes items such as: money at call and short notice, deposits/CDs maturing within one month, cash & short term funds – unclassified, and government treasury bills.
- Liquid assets - Category 3: This includes deposits/CDs maturing over one month and unclassified deposits/CDs.

Any bank must acquire sufficient liquid assets to meet its obligations to depositors. In addition to minimize risk, it must acquire assets that have a low rate of default risk and diversify asset holdings.

The liquidity ratio, is an indicator of a bank's capability to meet its obligations to depositors, and it may be identified as, liquidity to assets ratio and liquidity to deposits ratio. For Kuwaiti commercial banks, liquidity assets ratio in 2001, ranged between 9.56% for Al-Ahli Bank and 31.82% for the Commercial Bank of Kuwait. For all commercial banks, the average ratio is 22.87%. (Table 4.9 and figure 4.6).

Table 4.9. Kuwaiti Commercial Banks Ranking According to Liquidity Assets Ratio (LAR) - (Amount in Million KD; Year 2001)

Banks	Liquid Assets Amount Category (I+II+III)	Total Assets	Liquid Assets Ratio (LAR)	
			%	Rank
Commercial Bank of Kuwait	537.925	1,690.641	31.82	1
National Bank of Kuwait	1103.885	4,470.164	24.69	2
Burgan Bank	343.717	1,486.638	23.12	3
Gulf Bank	397.029	1,878.209	21.14	4
BKME	201.462	1,080.963	18.64	5
Al-Ahli Bank of Kuwait	113.301	1,185.472	9.56	6
Total for All Commercial Banks	2697.319	11792.087	22.87	

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

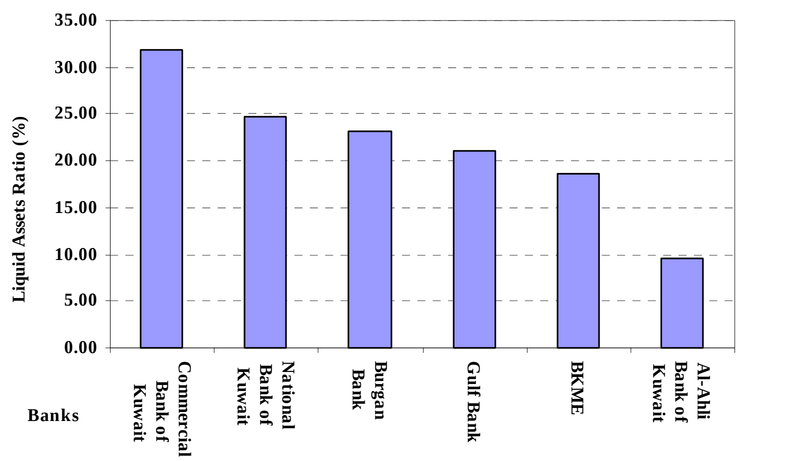


Figure 4.6. Kuwaiti Commercial Banks Ranking According to Liquidity Assets Ratio (LAR)

Needless to say, lower ratios reflect greater risk and higher ratios reflect greater conservation and risk aversion. The bank must manage the liquidity of its assets so that it can satisfy its reserve requirements without bearing huge costs. This means that it may prefer to hold liquid securities (i.e. treasury bills) even if they earn a somewhat lower return than other assets. On the other hand, it is not wise for a bank to be too

sensitive. It is true that acquiring more liquid assets means less risk and less cost, but it also means higher opportunity cost and less return. Therefore, bank management must balance its desire for liquidity against the increased earnings that can be obtained from less liquid assets such as loans.

Table 4.10. Kuwaiti Commercial Banks Ranking According to Liquidity Deposit Ratio (LDR) - (Amount in Million KD; Year 2001)

Banks	Liquid Assets Amount Category (I+II+III)	Deposit Liabilities	Liquid Deposit Ratio (LDR)	
			%	Rank
Commercial Bank of Kuwait	537.925	1,314.194	40.93	1
National Bank of Kuwait	1103.885	3,834.896	28.79	2
Burgan Bank	343.717	1,226.834	28.02	3
Gulf Bank	397.029	1,611.509	24.64	4
BKME	201.462	903.647	22.29	5
Al-Ahli Bank of Kuwait	113.301	999.650	11.33	6
Total for All Commercial Banks	2697.319	9890.730	27.27	

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

The liquidity to deposits ratio is also useful when evaluating the financial position of a bank and its liquidity management. Of course it would be expected that, for a given bank, liquidity deposits ratios would move in line with the liquidity assets ratios, but it will be higher (since deposits are an element on the assets side). This can be seen when looking to table 4.10 and figure 4.7, which illustrate liquidity deposit ratios for Kuwaiti commercial banks in 2001.

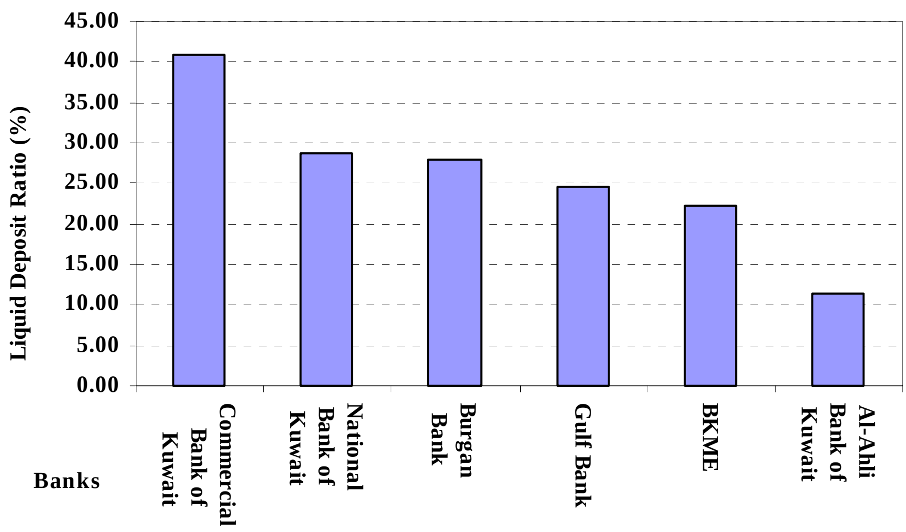


Figure 4.7. Kuwaiti Commercial Banks Ranking According to Liquidity Deposit Ratio (LDR)

Table 4.10 and figure 4.8 show that in 2001, the liquidity deposit ratio ranged between 11.33% for Al-Ahli Bank and 40.03% for the Commercial Bank of Kuwait. Lower ratios mean greater risk and aggressive liquidity management. Worth noting is that NBK's liquidity deposit ratios ranked second at 28.79%, with a substantial margin of 12.14% compared with that of the Commercial Bank (40.93%).

Another useful banking indicator is the loan (assets) deposit (liabilities) ratio, which reflects the bank's policy in managing the most important component of its assets. In order to maximize its profits, a bank will always try to seek the highest returns possible through an appropriate lending policy and balance that motivation with an acceptable level of 'risk', hence, banks try to find borrowers that are unlikely to default on their loans. Typically, banks are conservative in their loan policies; the default rate is usually less than 1%. It is, however, important that banks do not become overly-conservative so that they do not forgo rewarding lending opportunities that generate revenue.

In this regard, table 4.11 and figure 4.8 indicate that in 2001, loan deposit ratios ranged between 40.76% for the National Bank and 66.73% for the Commercial Bank of Kuwait. The lower ratio for the National Bank can be explained in terms of its larger size of deposits and more diversified asset management.

Table 4.11. Kuwaiti Commercial Banks Ranking According to Loan Deposit Ratio (2001) (Amount in Million KD)

Banks	Deposit Liabilities	Loan Assets	Loan Deposit Ratio %	Rank
Commercial Bank of Kuwait	1,314.194	877	66.73	1
Gulf Bank	1,611.509	987	61.25	2
Al-Ahli Bank of Kuwait	999.650	572	57.22	3
BKME	903.647	425	47.03	4
Burgan Bank	1,226.834	544	44.34	5
National Bank of Kuwait	3,834.896	1563	40.76	6
Total for All Commercial Banks	9,890.730	4968	50.23	

Source: Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

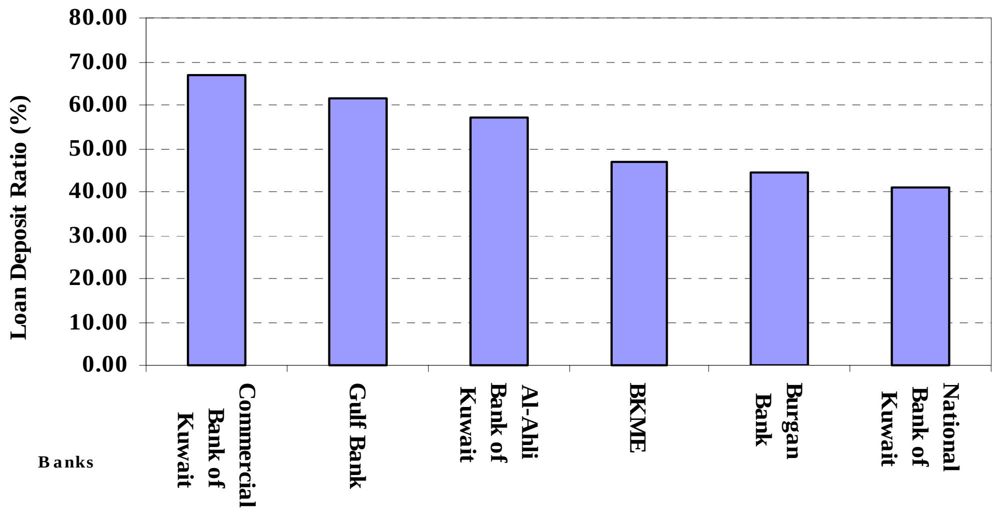


Figure 4.8. Kuwaiti Commercial Banks Ranking According to Loan Deposit Ratio (2001)

4.4.6. Structure and Characteristics:

The Kuwaiti banking sector comprises six locally incorporated commercial banks, one foreign bank operating as a branch, two specialised banks (Kuwait Real Estate Bank and the Industrial Bank of Kuwait), and the Kuwait Finance House (KFH). Kuwait is also

home to Gulf Investment Corporation, which is equally owned by the six GCC states. Despite efforts by The Kuwait Central Bank (KCB) to promote bank mergers, the result of an over banked market, the structure of the banking sector has remained unaltered in the last two and a half decades. With most domestic banks now fairly profitable, and with ownership structures rationalized, the perceived need for mergers has decreased considerably over the past few years. Through the country's privatisation program, the ownership of most banks has changed. Government ownership in Gulf Bank, Burgan Bank, Al-Ahli Bank of Kuwait and The Commercial Bank of Kuwait has now been effectively transferred to the private sector. The government still holds large stakes in two commercial banks, (Bank of Kuwait and the Middle East - BKME and Kuwait Finance House - KFH). Foreign ownership has been permitted to the extent of 40% of a bank's capital since 1994.

The structure of the Kuwaiti banks' balance sheets reveals that 31% of their ending 1999 total assets were made up of government exposure whereas 43% was in the form of private sector claims. The balance of total assets was mainly composed of foreign assets (14% - largely bank placements) and local interbank deposits (8%). As such, the largest risk to which the Kuwaiti banks are exposed to is credit risk. The banking sector has positioned itself for a period of low economic growth. This is reflected in table 4.1 which shows a low rise in the banks' total assets in both 1998 and 1999. However, claims on the private sector have continued to expand at 6% in 1999 and 12% in 1998. However this rate of growth is much lower than the 36% growth rate experienced in 1997, fueled by margin lending and a strong stock exchange. The banks' net foreign assets have also come under increasing pressure over the last three years, with the net position gradually decreasing from KD 1.4 billion in 1996 to KD 609 million at the end of 1999. The debt settlement program has been instrumental in the revitalization of the Kuwaiti banking sector as Government Development Bonds (GDBs) have been gradually replaced by new credits over the last eight years. In 1992, 52% of the banks' total assets were in the form of GDBs as against an all time low of 14.9% in 1999. The Kuwaiti banks continue to be highly capitalised, with a total capital to total assets ratio of 11.6%.

4.4.7. Specialised Banks

The Industrial Bank of Kuwait (IBK) and the Kuwait Real Estate Bank (KREB) are the country's two specialised banks. Their main function is lending to industry and the real estate sector, respectively, however, their overall impact on the financial system is

negligible. It is important to note that KREB has been trying to market and position itself as a traditional commercial bank over the past number of years, in an attempt to capitalize a larger share of the financial market in the country. Nevertheless, KREB is still perceived as a bank dedicated almost entirely to real estate loans in the mindset of potential customers, although this perception is slowly shifting.

4.4.8. Other Financial Institutions

Apart from KFH, there are a number of Islamic financial institutions that have been created during the 1990s. One, established in 1992, is The International Investor (TII). TII is owned by Al-Rajhi Banking and Investment Corporation of Saudi Arabia, the Public Institution for Social Security, the Ministry of Awqaf and Islamic Affairs and the Public Authority for Minors Affairs of the Ministry of Justice. TII has made a prominent and successful start to its operations and focuses primarily on fund management, corporate finance, advisory services and franchising. As of end 1998, TII had assets amounting to US$95 million, generating a net income of US$16.9 milion on a total capital of US$80 million. TII managed funds on behalf of investors to the tune of US$2.6 billion in 1999. Another Islamic investment house, established in 1993, is the International Investment Group (IIG) whose operations are comparable to those of TII.

4.5. Growth of Kuwaiti Banks:

Local Commercial Banks

The branch network of Kuwaiti banks can be divided into three tiers. The first tier is represented by the National Bank of Kuwait (NBK), the flagship bank of the country, which boasted 38 branches at the end of 1998. Even though the Gulf war had severe effects on the domestic banks' networks, with NBK reducing its number of branches by more than 40% between 1989 and 1992, the bank has continued to maintain leadership in all respects, including on the basis of its branch network. The second tier regroups three retail oriented banks, the Commercial Bank of Kuwait (CBK), Kuwait Finance House (KFH) and Gulf Bank (GB). KFH is the only bank that retained its network at pre-invasion levels in the post invasion period; the other two institutions cut their branches. The third tier is constituted by Al-Ahli Bank of Kuwait (ABK), Bank of Kuwait and the Middle East (BKME) and Burgan Bank (BB).

All three have historically emphasized wholesale banking, hence the relatively small number of branches *vis-à-vis* its peers. However, in recent years, these banks have focused increasingly on introducing retail-based services, and having recovered from financial difficulties in the early 1990s, they have invested heavily in technology and product development in order to capture a higher share of the lucrative retail business. Table 4.3 shows growth of total assets of Kuwaiti banks since 1993.

4.5.1. Banks' Overseas Operations

Each of the commercial banks operates overseas offices, however, in the aftermath of the Gulf war, many banks closed large portions of their international networks. NBK is the sole Kuwaiti bank, and in fact, the only one of a few Arab banks, which boasts a significant international presence. It operates offices in the UK, France, Lebanon, Switzerland, US, Singapore, Bahrain, Vietnam and Bahrain. The other banks do have some representation overseas but they are limited in scope and nature. CBK operates a New York branch, and ABK maintains a prosperous Dubai branch and a representative office in China, the only Kuwaiti bank to do so.

4.5.2. Performance of Kuwaiti Banks

Banks' Market Share:

The customary assumption is that market share in banking is based on total assets. This is perhaps no longer as good a measure as it was in the past. Banks are increasingly trying to restrain asset growth (to improve ROA), and are alternatively channelling their investments toward the development of non-interest sources of income such as asset management. NBK is the largest bank in the sector but also has the largest presence on the international market among Kuwaiti banks. Its market share has hovered at more than 30% during most of the 1990s, peaking at 35.2% in 1996. However, this figure declined to 32.1% in 1998 as management refrained from growing the balance sheet during what it considered periods of very high credit growth and in anticipation of declines in the stock market and oil prices. During the 1990s, Kuwait Finance House (KFH) is proving to be a success story, growing from the second smallest bank in the sector to the third largest, with prospects of overtaking Gulf Bank (GB) over the next several years. This reflects its success in delivering Shari'a-based products and its monopoly status as an Islamic bank.

4.5.3. Asset Quality

Table 4.17 indicates that the banking sector as a whole continued to maintain relatively strong loan-loss reserves against doubtful debt. Here again, the coverage ratios among the banks vary to a great extent (the lowest ratio was at about 69% whereas the highest at over 100%) and an analysis of the banks' asset quality must therefore be executed on a case-by-case basis. The banks' provisioning practices and requirements are closely scrutinised by the Central Bank of Kuwait, KCB and by two external auditors at every bank. In this respect, none of the Kuwaiti banks' audit reports have been qualified in recent years, with respect to shortfalls in loan-loss reserves. KCB introduced a regulation in 1996, which stipulates that banks must build a general provision to the extent of 2% of their loan book and contingent liabilities by year-end 2000. As of the end of 1999, most of the banks had satisfied that requirement.

The improvement of the banks' NPLs situation in the 1990s is largely attributable to the rapid expansion of credit since 1992. The bulk of the banks' NPLs relate to the pre-invasion period extended to clients outside Kuwait, mainly sovereigns. The ratio of NPLs (non-performing loans) to gross loans drifted downwards up to the end of 1997 but increased slightly during 1998. In fact, all Kuwaiti commercial banks, except for NBK, experienced a rise in their NPLs in 1998 as much tougher economic conditions prevailed. However the movement in NPLs, both in absolute and relative terms, varied widely between the banks; therefore it is important to analyse the trends in default rates of the individual banks, also taking into consideration the growth trend in their loan portfolios. With the recovery of oil prices, and with more buoyant trading conditions expected, asset quality should improve this year.

4.5.4. Distribution of Loan Portfolio

Table 4.18 gives a break down of domestic loans by sectors. Due to the narrow scope of the local economy, the Kuwaiti banks have heavy loan concentrations to the personal, real estate and trade sectors. Together, these accounted for about 70% of total loans granted in the country at the end of 1999. The personal sector, which includes consumer loans, represents by far the single largest exposure. However, one must bear in mind that in Kuwait personal lending includes borrowings by trading houses or large business concerns, which are family owned. Therefore, the personal sector, like the country's oil and petrochemical industries, is an integral part of bank activities. As KCB moved to limit margin trading and limit the growth in consumer lending in mid 1997, it

can be observed from the above table that loans to the personal sector shrank markedly in relative terms in 1998 and 1999. The percentages should be viewed in the context of an overall increase of 16.3% in total system loans. Volumes grew in all sectors apart from personal facilities and agriculture & fishing.

An important factor when assessing asset quality in Kuwait is the issue of security. In this context, enforcing debt and realising collateral can be difficult due to the legal system and at times it can take years before a debt is recovered. Often, banks have to resort to writing off bad debts as the chance of recovery diminishes with time.

4.5.5. Capitalization

Kuwaiti banks, without exception, are well capitalised, boasting risk asset ratios (RAR) which are considerably higher than the minimum standard ratio recommended by the Bank for International Settlements (BIS) as is indicated in table 4.19. In 1997, KCB lifted the minimum requirement for the capital adequacy standard for local banks to 12%, from 8% previously. All banks meet this requirement. What is more of an issue is the lower level of provisions held against bad debt at some banks, which could constitute some impairment of capital.

However, even if these banks took 100% provisions, they would still be in a position to comfortably meet the minimum capital adequacy requirement. As in the past, but to a lesser extent, the capitalisation of domestic banks continues to be driven by the high level of government securities on their books, which carry zero risk weightings. For the banks that still have large portfolios of GDBs, their risk asset ratios tend to be on the higher side. [10]

4.5.6. Liquidity

The Kuwaiti banks' liquidity position is fair even though many banks still hold significant amounts of illiquid GDBs in their books.[11]Accordingly, the banks' liquid assets (excluding GDBs) comprising cash, central bank deposits, government securities and local and foreign interbank assets (most of which are short-term in nature) accounted for 22% of total assets at end 1999, down from 28% in 1998. Similarly, the loans to

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[10] The general trend is however, for the ratios to decline commensurate with the redemption of GDBs and the corresponding increase in risk assets, mainly loans. CI's estimated BIS risk asset ratio improved in 1999 and so did the total capital to total assets ratio, both indicative of strong capitalisation.

[11] Using central bank publication, a rough liquid asset ratio for the whole banking sector can be computed.

deposits ratio for the banks (private sector claims relative to private sector deposits), although tightening from 73.7% in 1998 to 77.8% last year, is not a reason for concern at this stage. However, and as previously mentioned, the banks' net foreign assets have come under some pressure last year, with the net position gradually decreasing from US$3 billion in 1997 to US$1.8 billion in 1999. Analysing their position on the international interbank market; (banks became net borrowers in that market from the third quarter of 1997), net liabilities increased from US$1.1 billion in 1997 to US$1.3 billion in 1999 (slightly better than 1998). Nevertheless, should the banks require, they have the option and capacity to raise considerable funds from unused bank lines.[12]

As is common in the Gulf, the banks are exposed to asset/liability maturity mismatches, mostly due to the short-term nature of their customer deposits and the long tenor of the GDBs. The extent of the mismatch varies considerably among the banks but, in general, the greater the percentage of GDBs in the balance sheet, the larger the mismatch. However, the asset liability maturity gap was much larger in the early years after liberation but it has been reduced in recent years and will decline further with the continuing redemption of GDBs.[13]

4.5.7. Profitability

Both 1998 and 1999 were difficult years for the domestic economy in Kuwait and this had an inevitable effect on trading conditions for the banks. Apart from pressure on margins and the need for heavy investment in IT in relation to the Year 2000 compliance, the banks showed reasonable performance in both years. The combined net income of the seven domestic banks declined slightly in 1998, down by just 2% to US$624 million. In 1999 profits grew by 11.9% to US$ 698 million. Table 8 exhibits banks' peer group average profitability ratios.

The banks' bottom lines in 1998 were mostly affected by the need for higher provisioning requirements; overall, their operating profits to average assets ratio remained at 2% for both years, the same level as achieved in 1997. Also keeping pressure on the

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[12] In a stress situation, KCB would provide liquidity for GDBs through discount and swap facilities. Adding further comfort to the sector's liquidity scenario, the central bank has never failed to support banks in the past.

[13] In October 1997 KCB introduced a regulation based on a maturity ladder matrix, which provides limits as to the asset liability mismatches by maturity up to one year. Few banks have issued medium and long-term debt but such an exercise would help to diversify the banks' funding base and, therefore, reduce overall liquidity risk.

banks' returns was the rise in operating costs as large outlays were recorded for the purchase of IT equipment and investments related to upgrades of systems in view of the Year 2000 problem. This is reflected in the rise of the cost to income ratio to about 36%; a percentage that denotes the banks' superior cost controls and tightly managed structures.

The current year promises to be much more favourable for the banks. Although higher oil prices have still to show through in the form of higher government spending, this is expected to rise in the second half of the year. Consumer demand is already rising in anticipation of higher earnings and this will allow the banks to resume asset growth.

4.5.8. Accounting Standards

Kuwaiti banks produce accounts that are audited in accordance with International Accounting Standards. They are required to be audited by two accounting firms from an approved list maintained by the Central Bank of Kuwait. All the firms on the list are part of one of the major international accountancy groups. The level of disclosure varies among institutions; however, it is generally good. The trend is towards greater disclosure.

4.5.9. Ratings of Local Commercial Banks

Capital intelligence (CI) ratings are summarised in table 4.21. The ratings show the probability that a bank will require external assistance to overcome adversities. CI foreign currency ratings assess the likelihood that obligations will be repaid in a timely manner. The foreign currency ratings take into account all sovereign risk factors and are subject to the sovereign ceiling of the host country. Foreign currency ratings assigned to an institution will not normally breach the sovereign rating assigned to the country by CI. Both CI's long and short-term foreign currency ratings take into account the full impact of transfer risk and the risk that the host country may be unable or unwilling to service its foreign currency obligations.

CI's domestic strength ratings, based on domestic currency, indicate the CI's opinion of a bank's inherent financial strength and risk profile. Domestic strength excludes the foreign currency obligations and support factors. Domestic strength ratings do not assess the likelihood that specific obligations will be repaid in a timely manner. It summarises the probability that an institution will require external assistance from third parties to overcome adversities.[14] All banks in Kuwait show overall good performance.

[14] In assigning a domestic strength rating, CI considers both internal and external factors. Internal factors include financial fundamentals, business operations and market position. It also includes the bank's

4.5.10. The Current Competitiveness of the Banking Sector in Kuwait

The banking sector in Kuwait is dominated by six commercial banks at least two of which are large enough relative to the total banking industry and that have a relatively overwhelming influence on the money market. According to economic theory, this situation would be classified as an oligopolistic case, which includes a group of banks, each of which keeps a watchful eye on the actions of their competitors. Such actions and reactions include the frequent introduction of new banking services, discounts on some transactions and transfers, and advertising campaigns.

On the other hand, when considering the size differential between the six Kuwaiti commercial banks, we find some imperfection, since the National Bank of Kuwait is relatively the dominant bank that captures about 40% of the total commercial banking market, in terms of asset size, liability deposits, and assets loans. Hence, it is a very distinct oligopolistic case, where there is one specific leading bank with the rest of the banks mostly behaving as followers. These conditions may constrain competition in the local money market. Hence, it may be argued that the Kuwaiti commercial banking sector is approaching duopoly, due to the existing interdependence between any National Bank's actions on one hand, and the reactions of the other banks on the other. This local market situation, in addition to government protection and the restricted ownership of banks has hindered competition between local commercial banks in Kuwait.

4.6. Competitiveness of the Kuwaiti Banking Sector in the GCC

According to the GCC's unified economic agreement, member states should coordinate their financial, cash and banking policies and increase cooperation between the cash institutions and central banks including the standardization of currency.

Banking activity in the GCC countries is subject to a variety of restrictions. In Kuwait, foreigners may be allowed to own up to 49 percent of a Kuwaiti bank, subject to approval by the Central Bank. In Saudi Arabia, foreigners are permitted to own up to 40 percent of banks. However the Saudi government has decided to allow GCC banks to open branches in the Kingdom. In the U.A.E., Oman, and Qatar, there are laws permitting foreign banks to operate. These countries however, have barred new non-

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operating environment, including the economy, the structure, strength and stability of the financial system, the legal system and the quality of banking regulation and supervision.

GCC banks from establishing operations on the grounds that an over-banked situation exists in these countries. Although in 1997, the GCC initiate steps to facilitate GCC-based banks operating branches in other GCC states, no new foreign banks have begun operating in the U.A.E. in the past few years. Bahrain is the only GCC country where financial institutions operate without impediments and offshore banking is permitted (Trade Compliance Center, 2002).

Regionally speaking, the main general features of the GCC banking system are very much similar to what exists in Kuwait with relatively few and small government supported banks with very restricted and limited foreign participation and ownership, and consequently, a low degree of competition.

Within the GCC member countries, the available data for 2001 indicates that the Kuwait banking sector occupies fourth place according to total asset size. Saudi Arabia, Bahrain and the U.A.E. are first, second and third, consecutively.

Asset size is the most important financial indicator, which reflects, to a great extent, the competitive capability of any banking institution in a given financial environment. Other indicators, which are usually used in comparative studies, are: size of deposits (liabilities), return on assets, return on equity, equity to asset ratio, liquid assets ratio and liquid deposit ratio. The importance of each of these financial indicators would depend largely on the subject under study. For example, the proportional structure of assets and liabilities are of great importance when evaluating assets and liabilities management.

Liquidity ratios do not tell much about the competitive status of banks, while they are essential in identifying the bank's capacity to meet its obligations to depositors. Therefore, despite the fact that the data of 2001 indicate that the Kuwaiti banking sector occupied advanced places with respect to some of these indicators, first in liquid ratios, second in return on equity ratio, and third in return on assets and equity to assets ratios, it is not appropriate to conclude that the Kuwaiti banking sector can be ranked first or even second, with respect to competitiveness within the GCC region. A ranking between third and fourth place would be more acceptable according to all indicators in general and the relative size of assets in particular (Table 4.12, figure 4.9(a) and figure 4.9.(b).

Table 4.12. Comparative Financial Ratios in GCC Banks (2001)

Banks	Total Assets		Return on Assets (ROA)		Return on Equity (ROE)		Equity to Assets		Liquid Assets Ratio (LAR)		Liquid Deposit Ratio (LDR)	
	Million US$	Rank	%	Rank	%	Rank	%	Rank	%	Rank	%	Rank
Kuwait	41,881.18	4	1.96	3	14.71	2	13.33	3	12.47	1	15.47	1
UAE	51,065.68	3	1.99	1	13.04	3	15.30	1	10.22	2	12.63	2
Saudi Arabia	83,368.40	1	1.98	2	18.85	1	10.52	5	4.04	5	4.77	5
Qatar	11,594.72	5	1.63	4	10.99	4	14.83	2	7.07	4	8.54	4
Oman	9,860.70	6	0.48	6	3.96	6	12.02	4	8.77	3	11.18	3
Bahrain	54,644.12	2	0.53	5	5.91	5	9.00	6	2.48	6	3.24	6
All GCC Banks	252,414.80		1.59		13.41		11.88		6.68		8.22	

Source: GCC Banks: Financial Report 1999-2001, Institute of Banking Studies, Kuwait

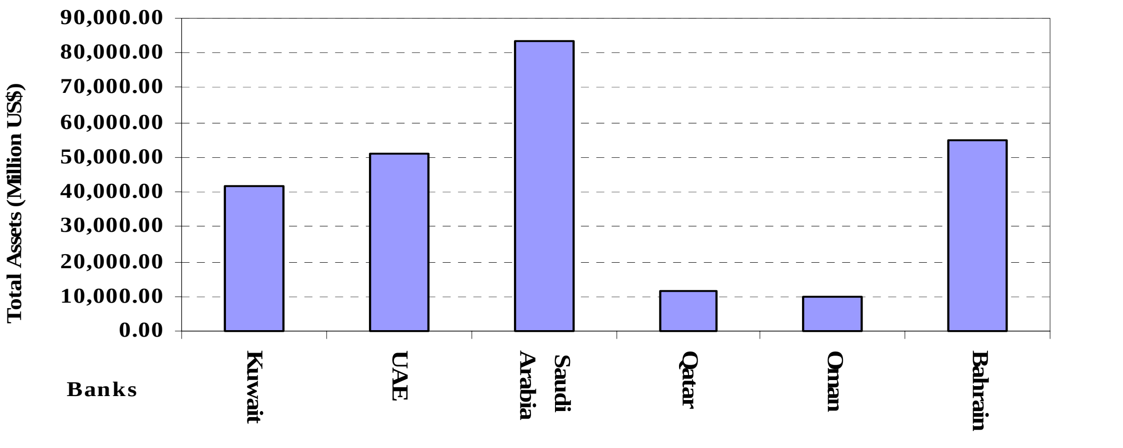


Figure 4.9-A. Comparative Total Assets in GCC Banks (2001)

4.7. Is Merging an Option or a Necessity

There are many forces, which have been driving the international bank merger wave. Among these forces, technology has been identified as the fundamental driving force. The extraordinary advance in communication and data processing technology over the last two decades made it possible for banks to provide widespread access to their records at branches and automated teller machines. The explorations of such advances have resulted in cost savings, especially when managing information of very large databases. Therefore, the benefits of the technology revolution accrue most fully to very large-scale banks. Other factors, which are also cited as driving forces, are:

– The anticipation of higher business retention rates.

- The provision of more effective credit management with stronger reserves.
- The ability to resolve credit problems quicker with lower impact of credit costs.
- Stronger capital base.

The case of Kuwait is somewhat different from the general international trend. Existing conditions have almost isolated commercial banks from external competition through legal and regulatory barriers against the entry of foreign banks. Furthermore, restrictions on establishing new banks have also depressed local competition and hindered the effectiveness of market forces in adjusting the banking industry. Lately, there has been a sound call for a gradual removal of legal and regulatory barriers, as preparation for a new era of a more competitive banking market, which will be driven by the following forces:

- The implementation of WTO agreements.
- The regional (GCC) pressures on local authorities to open their financial market to other GCC based banks in order to improve competitiveness.
- The future challenges from international banks that will have access to local and regional financial markets.
- Advanced applications in computer and communications technology with the introduction of new financial instruments.
- The increasing challenges from non-banking institution such as investment companies, some of which are beginning to attract funds management from traditional banks.
- The abolition of a government deposit guarantees system.

All of the above mentioned forces would make it necessary for local and GCC banks to urgently consider a merger strategy in order to improve their competitive edge and to enhance and build a stronger market position.

4.8. Prospects and Challenges

The Central Bank of Kuwait (KCB) is empowered to regulate and supervise the country's financial system. Its supervision covers all seven commercial banks operating in Kuwait, three specialised banks, and investment and money-changing companies, which were brought under KCB's direct supervision in 1987 and 1984 respectively. KCB also acts as lender of last resort to the banking system. KCB's track record in supporting the banking system has thus far been exemplary. The Central Bank of Kuwait intervened in 1982 as a result of the crash of the informal stock exchange, providing relief

to the banks and debtors alike through the placement of interest free deposits and the introduction of the bad debt settlement program in 1986. The monetary authorities bailed out the banking sector again after the Gulf war through the implementation of Law 32 of 1992 empowering the Central Bank to purchase all the banks' domestic non-performing loans. Over the last few years, this law has been amended a number of times, providing debtors with additional lenient terms under the program. Nevertheless, several years into the debt settlement program, KCB is unlikely to reduce its support to the banking sector if it were to face a systemic crisis. This would be intended to foster more self-reliance on the part of the banks' shareholders and management, which have always looked for, and received, support from the authorities in time of hardship. Parallel to this, KCB has progressively tightened its regulatory and supervisory functions over the last few years. Banks are currently managed more professionally than in the past and this has reduced the risk of bank failure to a considerable extent.

The rise in GDP in 1999 did not translate into higher government spending, particularly capital spending. This meant a dull economic environment and a dull stock exchange. The KSE, having fallen by 31% in 1998, rose by only 4.7% in 1999. Despite this unpromising trading environment, the banks performed relatively well. Profits generally rose, although there were some variations in performance levels (sometimes due to one-off factors). Although some banks saw a rise in NPLs, such rises were moderate in both monetary value and in percentage terms. Of the six commercial banks, three saw a fall in NPLs. Despite continuing dull economic conditions in the domestic economy in the first quarter of 2000, bank performances were generally improved. The current year promises to be a good one for Kuwaiti banks; if oil prices continue to hold at or near current levels, next year could see even stronger results.

4.9. Conclusions and Remarks

Financial markets, especially the banking sector in Kuwait was at a rudimentary stage in 1970s. A large part of domestic liquidity was in the form of cash. Today's scenario in the banking and financial sector in Kuwait is characterized by deregulation, globalisation, product innovation, high technology, better management and increased competition. Most of the Kuwaiti banks are performing modern banking services and have changed traditional banking activities. This change has created great potential for gain and has inevitably increased the risk factor. The evaluation of bank performance is a complex process involving interactions between the environment, internal operations,

and external activities. Our analyses of banks' internal performance (by analysing the financial ratios of accounting items) show that most of the Kuwaiti banks performed well over the past few years. External performance is measured by evaluating the bank's market share, regulatory compliance, and public confidence. In this area of external performance Kuwaiti banks show remarkable progress. The ratings of the Kuwaiti banks indicate good credit quality and a strong capacity for timely payment of foreign currency. In terms of domestic strength, most of the banks show financially strong and sound conditions. Overall, all banks' short term outlook is either stable or positive.

Kuwait needs to integrate its financial system with the rest of the GCC countries. Harmonization of the bank supervisory systems of the GCC countries towards international supervisory standards and regulation has contributed immensely to the safety of the banking system and the banks' competitiveness. Central monetary authorities are very proactive in terms of supervising and monitoring the banks. The issue of bank mergers has topped the agendas of the respective Central Banks. Bank mergers are expected to be restricted to the national level at least in the short and the medium term. Monetary authorities do not encourage such interstate mergers, preferring initial strategic decisions to be taken at the national level and later expanding across GCC borders. However, GCC banks need to be more global in outlook and should focus on the increasing trends towards securitization of their assets. Following the trends of the international banks, GCC banks should diversify their product base into the area of corporate finance, investment management including mutual funds, mergers and acquisitions, and consulting services.

Table 4.13. Balance Sheet of Local Banks (KDmn)

	1994	1995	1996	1997	1998	1999
Assets:						
Cash and Central Bank	151.8	158.1	123.0	79.0	98.0	135.2
Foreign Assets	1926.5	2130.8	2168.2	2117.6	1787.7	1786.5
Local Interbanks	801.0	577.1	662.5	972.6	1088.2	988.0
Claims on Government:	5634.4	5391.4	4573.4	4362.5	4140.3	4062.2
-Debt Purchase Bonds	3848.1	3393.8	2845.0	2389.1	2245.8	1930.6
-Public Debt Instruments	1786.3	1997.6	1728.4	1973.5	1894.5	2131.5
Claims on Private Sector	1950.5	2805.2	3502.7	4744.5	5302.9	5619.9
Other	502.1	529.4	430.2	413.7	447.9	368.9
Liabilities:						
Private Sector Deposits	6391.6	7063.2	6980.7	7270.7	7207.8	7227.6
Government Deposits	421.3	459.4	374.1	343.6	256.8	195.0
Foreign Liabilities	713.4	669.3	760.7	1222.4	1084.2	1177.5
Local Interbanks	810.2	547.2	659.4	1043.0	1291.8	1249.4
Capital and Reserves	1090.1	1201.5	1295.7	1408.5	1564.6	1502.5
Other	1539.9	1651.5	1389.5	1401.7	1618.6	1614.5
Totals	**10966.5**	**11592.1**	**11460.1**	**12689.9**	**12875.1**	**12966.6**
% Change	**10.3**	**5.7**	**-1.1**	**10.7**	**1.5**	**0.7**

Source: Kuwait Central Bank's monthly and quarterly statistical bulletins

Table 4.14.Growth of Local Commercial Banks' Branch Numbers

Banks	1989	1992	1993	1994	1995	1996	1997	1998	1999
National Bank of Kuwait	51	30	32	31	34	35	35	38	38
Commercial Bank of Kuwait	36	16	16	18	18	21	21	22	23
Kuwait Finance House	17	16	16	17	17	18	19	21	21
The Gulf Bank	28	14	15	15	15	16	20	20	21
Al-Ahli Bank of Kuwait	21	9	10	9	10	12	12	12	12
Bank of Kuwait & Middle East	21	9	11	9	10	11	12	13	15
Burgan Bank	13	6	10	9	8	10	11	11	12
Total	**187**	**100**	**110**	**108**	**112**	**123**	**130**	**137**	**142**

Source: Kuwait Central Bank's monthly monetary statistics

Table 4.15. Total Assets of Kuwaiti Banks (US$)

Banks	1993	1994	1995	1996	1997	1998	1999
National Bank of Kuwait	10,945	13,230	12,927	13,066	13,506	12,732	12,490
The Gulf Bank	4,170	4,616	4,844	5,404	5,685	6,106	5,845
Kuwait Finance House	3,873	4,264	4,668	4,734	5,185	5,542	5,817
Commercial Bank of Kuwait	3,584	3,386	4,006	3,802	4,180	4,527	4,534
Al-Ahli Bank of Kuwait	3,431	3,634	4,145	3,930	4,094	3,861	3,821
Burgan Bank	2,584	2,858	3,171	3,220	3,764	3,716	3,779
Bank of Kuwait & Middle East	2,611	2,809	3,159	2,971	3,011	3,130	2,951
Total	**31,198**	**34,797**	**36,920**	**37,127**	**39,425**	**39,614**	**39,237**
% Change	**-4.0**	**11.5**	**6.1**	**0.6**	**6.2**	**0.1**	**-0.1**

Source: Compiled from CI's spreadsheets.

Table 4.16. Market Share of Kuwaiti Banks (%)

Banks	1993	1994	1995	1996	1997	1998	1999
National Bank of Kuwait	35.1	38.0	35.0	35.2	34.3	32.1	31.9
The Gulf Bank	13.4	13.3	13.1	14.6	14.4	15.4	15.0
Kuwait Finance House	12.3	12.3	12.6	12.7	13.2	14.0	14.8
The Commercial Bank of Kuwait	11.5	9.7	10.9	10.2	10.6	11.5	11.5
Al-Ahli Bank of Kuwait	11.0	10.4	11.2	10.6	10.4	9.7	9.7
Burgan Bank	8.3	8.2	8.6	8.7	9.5	9.4	9.6
Bank of Kuwait & the Middle East	8.4	8.1	8.6	8.0	7.6	7.9	7.5
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Compiled from CI's spreadsheets.

Table 4.17. Asset Quality - Peer Group Average (%)

	1993	1994	1995	1996	1997	1998	1999
Prov Charge/Total Loans	-1.56	1.56	0.42	0.96	1.44	1.08	0.84
Loan-loss Provisions/Total Loans	24.36	20.20	16.33	9.74	9.56	9.78	11.06
NPLs/Total Loans	28.57	25.57	22.17	15.44	12.05	13.07	12.27
Loan-loss Provisions/NPLs	100.54	95.98	88.32	88.11	85.61	83.24	92.69

Source: Capital Intelligence (KFH not included in the above table)

Table 4.18. Banks' Domestic Loans by Sector (%)

	1993	1994	1995	1996	1997	1998	1999
Personal Facilities:	30.2	25.4	48.0	45.9	39.8	35.7	31.9
Consumer loans	-	-	23.5	16.2	12.7	11.5	10.9
Real Estate	7.4	9.3	9.1	13.3	15.6	17.5	19.9
Trade	39.1	34.1	17.9	16.4	16.3	17.0	18.5
Construction	6.1	8.6	6.0	6.5	7.0	8.2	7.3
Industry	3.1	7.1	6.8	7.1	8.6	7.8	7.8
Non-bank Financial Institutions	6.4	6.3	5.1	5.8	6.1	5.8	6.1
Agriculture/Fishing	0.4	0.2	0.4	0.3	0.4	0.2	0.2
Other	7.3	9.0	6.7	4.7	6.2	7.8	8.3
Totals	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Kuwait Central Bank's monthly and quarterly statistical bulletins
Note: Credit facilities of the trade, personal facilities and real estate sectors have been reclassified with effect from November 1995.

Table 4.19. Capital Adequacy Ratios - Peer Group Average (%)

	1993	1994	1995	1996	1997	1998	1999
Estimated BIS Ratio	18.0	16.3	17.7	16.7	14.7	14.9	15.6
Total Capital/Total Assets	10.7	9.9	10.4	11.3	11.1	11.0	12.4
GDBs/Total Assets	41.7	35.1	29.3	24.8	18.8	17.4	14.9

Source: Kuwait Central bank monthly and quarterly statistical bulletins and CI spreads

Table 4.20. Profitability Ratios - Peer Group Average (%)

	1993	1994	1995	1996	1997	1998	1999
Return on Average Assets	0.95	0.74	1.11	1.38	1.53	1.36	1.34
Return on Average Tier One Capital	11.83	8.97	13.46	14.95	15.14	13.13	11.84
Interest Differential	1.17	1.12	1.18	1.42	1.74	1.71	1.66
Operating Expenses/Gross Income	59.78	54.03	43.89	36.01	33.57	34.81	37.85

Source: Capital Intelligence

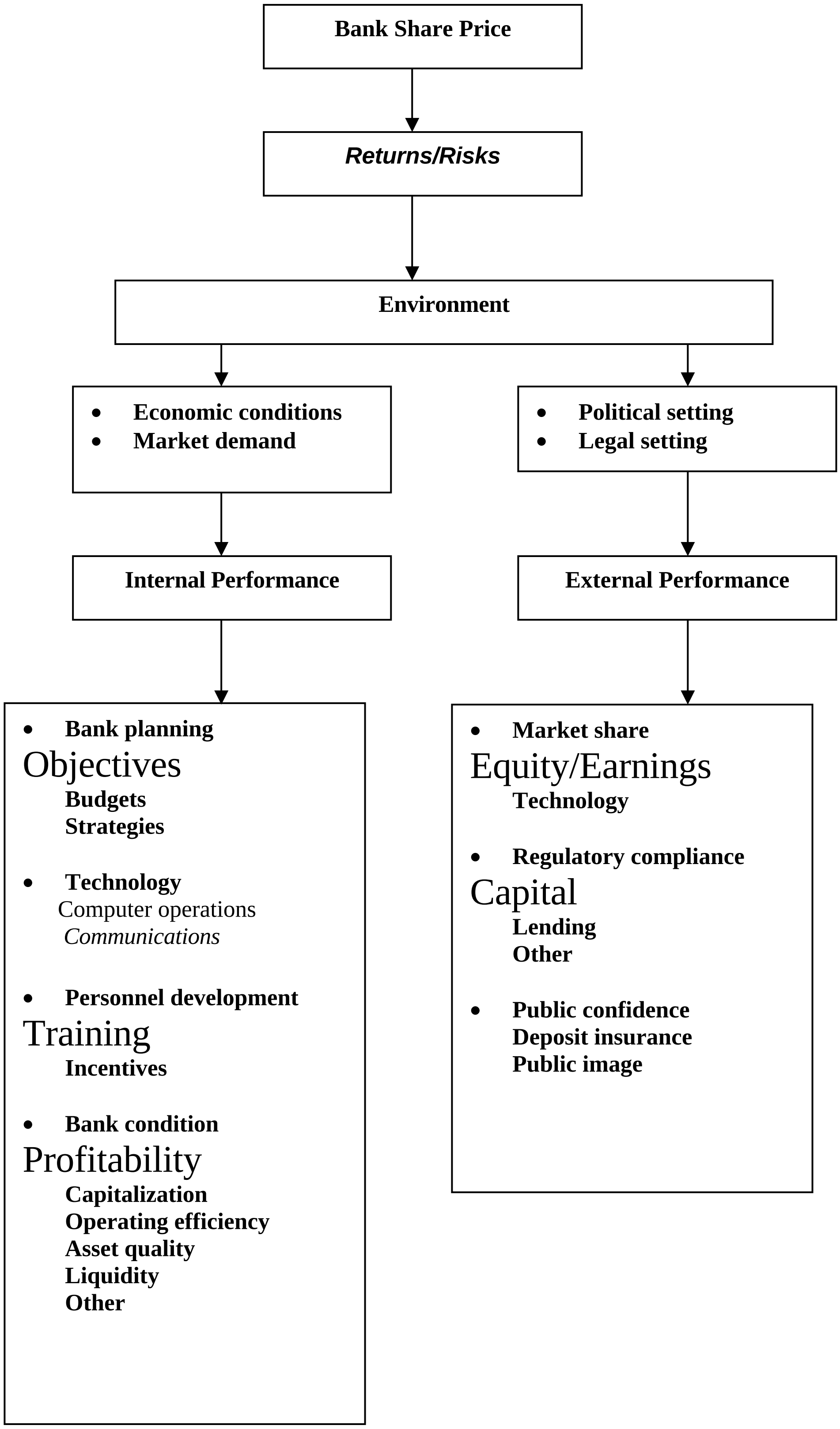
Table 4.21. Summary of Ratings of Commercial Banks of Kuwait

Sovereign Ceiling: Long Term: A

Banks	**Foreign Currency: L T**	**ST**	**Domestic Strength**	**Support**	**Outlook**
Al-Ahli Bank of Kuwait	BBB-	A3	BB+	3	Stable
Bank of Kuwait & Middle East	BBB	A2	BBB	2	Stable
Burgan Bank	BBB	A2	BB+	3	Positive
Commercial bank of Kuwait	BBB+	A2	BBB	3	Stable
Gulf Bank	BBB+	A2	A-	3	Stable
Gulf Investment Corporation	A-	A2	NA	2	Stable
Industrial Bank of Kuwait	A-	A2	A-	2	Stable
Kuwait Finance House	BBB+	A3	BBB+	2	Stable
Kuwait Real Estate Bank	B+	B	BB-	4	Stable
National bank of Kuwait	A	A2	AA-	2	Positive
A'Ayan Leasing & Invest. Co.	NA	NA	BB	3	Stable
The Investment Dar	NA	NA	BB-	3	Positive

Note: Foreign currency long-term (LT): "A" indicates high credit quality while "BBB" indicates good credit quality (Both are investment grades). Plus (+) or Minus (-) sign indicates that the strength of a particular institution is slightly greater or less than that of similar rated peers**. Foreign currency short tern (ST)**: "A3" indicates strong capacity for timely repayment but may be affected by unexpected adversities while "A2" indicates very strong capacity for timely repayment but may be affected slightly by unexpected adversities. (Both are investment grades). "B" is speculative grade that indicates capacity for timely repayment that could be seriously affected by unexpected adversities. **Domestic strength:** "AA" indicates financially in very strong condition and significant strengths in other non-financial areas. Operating environment likely to be very attractive and stable. "A" indicates strong financial fundamentals and very favourable non-financial considerations. Operating environment may be unstable but institution's market position and/ or financial strength more than compensate. Rating BBB" indicates basically sound overall; slight weaknesses in financial or other factors could be remedied fairly easily. May be limited by unstable operating environment. While "BB" indicates one or two significant weaknesses in the bank's financial makeup could cause problems and unstable operating environment likely. **Support ratings**: "3" indicates owners of very good reputation and resources, and which can provide clear support. Rating "2" indicates government support extremely likely despite absence of written guarantee. There may be some uncertainty regarding the government's willingness or ability to provide support. A private bank has extremely strong ownership. "4" indicates support is likely but not certain. **Outlook:** "stable" – no change or deterioration in rating over the 12 months following its publication.

Figure 4.10 A Framework for Evaluating Bank Performance



Part 5

Merging Options and Scenarios in the Kuwaiti Banking Sector

5.1. Introduction

Mergers and acquisitions continue to be an important phenomenon in the world economy. But why do banks merge? It is correct to state that every single merger has its own individual reasons, but for a long time researchers have been trying to find the general reasons, the ones that are common to most of the bank merger cases. Researchers are usually searching for a few general motives and determinants, but constantly find that each particular merger has its particular reasons.

Apart from general management objectives, such as increasing profitability by diversification and exploitation of economies of scale, dominating markets and governing large firms, the origin of the on going merger wave were found in technical progress (particularly in communication technology), deregulation, general globalization and the resulting competitive challenges for financial firms.

In Kuwait, it has been recognized that the national and international context in which the banks operate is undergoing a profound change. Globalization and technological innovation have vastly expanded the range of financial services available to business and consumers. These services can now be provided faster and more easily across geographic boundaries.

These forces bring banks tremendous opportunities and formidable challengers to the Kuwaiti Financial institutions. For Example, while domestic banks can adopt technologies to better serve their existing clients, the accessibility of technology also provides opportunities foe their competitors. In addition, while globalization and WTO agreements have allowed Kuwaiti banks to better serve their domestic clients, it is also meant that foreign providers of financial services have been able to make inroads into Kuwait financial market.

It is the purpose of this task to tackle the issue of merging in the Kuwaiti banking sector as a mean to cope with the changing international financial environments. This Include:

* Classifying players in Kuwait's banking system.
* Exploring domestic options.
* Preferred matches based on financial characteristics.
* Other options: regional and international mergers.

5.2. Classification of Players in Kuwait's Banking Sector

The institutional structure of the Kuwaiti banking and financial system, according to the Central Bank of Kuwait (CBK) classification, covers local banks, investment companies, exchange companies and investment funds. The term "local banks" includes: the group of seven commercial banks (National Bank of Kuwait, Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Gulf Bank, Burgan Bank, the Bank of Kuwait and the Middle-East, and the Bank of Bahrain and Kuwait), two specialized banks (the Industrial Bank of Kuwait, and the Kuwait Real Estate Bank), and the Kuwait Finance House.

The CBK, 2001, data indicate that the total aggregate balance sheet of the above defined local banks (commercial, specialized, and Kuwait Finance House) reached KD 15.0661 billion at the end of 2001.

We are concerned in our merging scenarios with the 100% Kuwaiti owned commercial banks, namely: National Bank of Kuwait, Gulf Bank, Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Burgan Bank, the Bank of Kuwait and the Middle-East. The following Table 5.1. represents the most important financial indicators for these banks at the end of the year 2001.

Table 5.1. Major Financial Indicators of Kuwaiti Banks (Amount in Million KD; Year 2001)

Banks	Return on Assets (ROA)		Return on Equity (ROE)		Equity to Assets		Assets		Loan Assets		Net Profit		Liquid Assets Ratio (LAR)*		Liquid Deposits Ratio (LDR)*	
	Rank	%	Rank	%	Rank	%	Rank	AMT.	Rank	AMT.	Rank	AMT.	Rank	%	Rank	%
National Bank of Kuwait	1	2.35	1	20.08	6	11.70	1	4470	1	1563	1	105.0	2	24.69	2	28.79
Gulf Bank	2	2.24	2	17.85	4	12.57	2	1878	2	987	2	42.1	4	21.14	4	24.64
Commercial Bank of Kuwait	3	2.07	3	15.42	2	13.44	3	1691	3	877	3	35.0	1	31.82	1	40.93
Al-Ahli Bank of Kuwait	6	1.18	6	8.82	3	13.42	4	1487	4	572	6	14.0	6	9.56	6	11.33
Burgan Bank	5	1.39	4	11.48	5	12.11	5	1185	5	544	4	20.7	3	23.12	3	28.02
BKME	4	1.45	5	10.50	1	13.85	6	1081	6	425	5	15.7	5	18.64	5	22.29
Total for All Commercial Banks		1.78		14.03		12.85		11792		4968		232.5		22.87		27.27

* Liquidity Category (I + II + III)

** Excluding Kuwait Finance House

Source: Prepared from Financial Operating Report 1998-2001, Institute of Banking Studies, Kuwait

5.3. Exploring Domestic Options

The Kuwaiti banking sector has relatively been protected from foreign competition and set service levels to appeal to the average consumer. But future open competition would force Kuwaiti commercial banks to differentiate themselves by service level. Large banks exploit the economies of large-scale production of wide range of banking services. Considering the existing banking conditions in Kuwait, merging between relatively small banks is needed to improve economies of scale and to be able to compete with large banks.

As it is shown in the pervious task (task 4), out of the six Kuwait commercial banks, the National Bank of Kuwait is relatively the largest, and dominates the local banking industry with about 40% of the market share. Therefore, when exploring the merging options between the local commercial banks according to assets size, we exclude the National Bank of Kuwait and other five banks had been our main players. Our Option results for merging between:

* The five banks is one case;
* Four banks are five cases;
* Three banks are ten cases;
* Two banks are ten cases;
* Two banks and two banks are thirty cases; and
* Three banks and two banks are ten cases.

All of the above cases (66 merging cases) are presented in the appendix of merging combinations.

5.4. Preferred Matches Based on Financial Characteristics

When examining all options of the merging results between the local Kuwaiti commercial banks, after excluding the National Bank of Kuwait (NBK), our preferred choices are determined according to the following criteria:

* A market share close to that of NBK is a preferred target for any merging action in order to create more competitive banking units.
* If : M_{ij} is the market share of the i^{th} merging activity, where i = 1, 2, …, n.
  S_j is the market share of the j^{th} scenario, where j = 1, 2, …, 66.

Then: (1) M_{ij} is more preferable as it gets closer to NBK market share.

(2) The scenario S_j is best liked if:

$\sum_{i=1}^{n}$ (NBK share – M_{ij}) is the least of all scenarios.

If the summation is less than 0, the absolute value of the outcome is taken. Appling the above stated conditions to our merging tables presented in the appendix, the following two scenarios (65 and 66) are generally favorable with superiority of scenario 36 since:

Scenario 65: $\sum_{i=1}^{2}$ (NBK share – M_{i65}) = (6.1 + 6.6) = 12.7 … (1)

Scenario 66: $\sum_{i=1}^{2}$ (NBK share – M_{i66}) = (4.3 +9.4) = 13.7 … (2)

Note that (1) < (2).

Therefore, according to the given criteria, scenario 66 is the best choice and scenario 65 is the second best for merging between the Kuwait commercial banks.

Table 5.2. Kuwaiti Commercial Merging - Scenario (66)
(Amount in Million KD)

Banks	**Assets**	**%**	**(NBK – M_i)**
National Bank of Kuwait	4470	37.9	0.0
Merged Banks (1)	3753	31.8	4.3
Merged Banks (2)	3569	30.3	9.4
Total for All Commercial Banks	11792	100.0	13.7

(1) Al-Ahli Bank of Kuwait, Burgan Bank, BKME
(2) Gulf Bank, Commercial Bank of Kuwait

Table 5.3. Kuwaiti Commercial Merging - Scenario (65)
(Amount in Million KD)

Banks	**Assets**	**%**	**(NBK – M_i)**
National Bank of Kuwait	4470	37.9	0.0
Merged Banks (1)	3957	33.6	6.1
Merged Banks (2)	3365	28.5	6.6
Total for All Commercial Banks	11792	100.0	12.7

(1) Commercial Bank of Kuwait, Burgan Bank, BKME
(2) Gulf Bank, Al-Ahli Bank of Kuwait

5.5. Other Options: Regional and International Mergers

While domestic mergers and acquisitions in banking have risen steadily for the past two decades, international mergers and acquisitions remained until recently relatively rare. Between 1980 and 2000, about one sixth for all bank mergers around the

world involved partners headquartered in two different countries[15]. However, this share varies greatly. In Europe, about one third of all bank mergers involved partners from different countries, with 20% of all cross-border mergers involving two European institutions. In Asia, about 40% of all bank mergers involved a partner headquartered in a different country, but only about 10% of bank mergers in Americas involved a foreign partner. Growth in the percentage of cross-border bank mergers has also varied by region. Compared to the 1980's, such mergers in the 1990 increased by 10% more of all mergers worldwide. In the Americas, the share of bank mergers that were cross-border increased by 5% between the two decades. In Europe, the share remained constant, and in Asia, the share of such mergers fell by 18%.

In the GCC region, there are 33 cross-border bank mergers, which involve foreign partners from different countries (see Table 5.4).

Table 5.4. Cross-Border Bank Mergers in the GCC Member Countries

Country	Acquires	Targets
Bahrain	15	3
Kuwait	7	0
Oman	1	3
Saudi Arabia	8	0
UAE	1	0
Total	33	6

Source: Thomson Financial Securities Data (2001)

There are many constraining factors which limit the success of international banking mergers. Such factors include geographical distance, different languages, cultures, or regulatory and supervisory structures. These factors affect the efficiency of cross-border banking mergers through information costs that tend to be higher between rather than within countries and differences in regulations.

With regard to the geographical distance, countries that are relatively close geographically can be expected also to share similarities in terms of culture, which tends to lower information cost.

[15] Unless indicated otherwise, these and the following information on merger characteristics have been taken from Thomson Financial Securities Data (2001).

Besides geographic proximity, sharing a common language is likely to lower the costs of melding two corporate cultures because information needs to be communicated in only one language. Furthermore, and more indirectly, sharing a common language can be seen as a proxy for common culture links.

While the geographic proximity between acquirer and target and the fact whether a common language is spoken addresses mainly the cultural aspect of information cost, legal aspects are also relevant. We expect that the presence of a common system has a positive impact on cross-border mergers and acquisitions.

In the case of the GCC member countries, all countries are neighbours, sharing the same language, and having a common legal system. These existing conditions would increase efficiency and gains from regional banking mergers and acquisitions. Therefore, it is more likely that cross-border bank mergers within the GCC region would gradually increase in the near future, either as a substitute or to support domestic mergers in member countries.

5.6. A Tabulation of Hypothetical Merging Options That May Exist Between Kuwaiti Commercial Banks

Table 5.5. Kuwaiti Commercial Merging - Scenario (1)
(Amount in Million KD)

Banks	**Assets**	**%**
National Bank of Kuwait	4470	37.9
Merged Banks*	7322	62.1
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Burgan Bank, BKME

Table 5.6. Kuwaiti Commercial Merging - Scenario (2)
(Amount in Million KD)

Banks	**Assets**	**%**
National Bank of Kuwait	4470	37.9
Merged Banks*	6241	52.9
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.7. Kuwaiti Commercial Merging - Scenario (3)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	6137	52.0
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, BKME

Table 5.8. Kuwaiti Commercial Merging - Scenario (4)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	5835	49.5
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Commercial Bank of Kuwait, Burgan Bank, BKME

Table 5.9. Kuwaiti Commercial Merging - Scenario (5)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	5631	47.8
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Al-Ahli Bank of Kuwait, Burgan Bank, BKME

Table 5.10. Kuwaiti Commercial Merging - Scenario (6)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	5444	46.2
Gulf Bank	1878	15.9
Total for All Commercial Banks	11792	100.0

* Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Burgan Bank, BKME

Table 5.11. Kuwaiti Commercial Merging - Scenario (7)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	5056	42.9
Burgan Bank	1185	10.0
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Gulf Bank , Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait

Table 5.12. Kuwaiti Commercial Merging – Scenario (8)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	4754	40.3
Al-Ahli Bank of Kuwait	1487	12.6
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Gulf Bank , Commercial Bank of Kuwait, Burgan Bank

Table 5.13. Kuwaiti Commercial Merging - Scenario (9)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	4550	38.6
Commercial Bank of Kuwait	1691	14.3
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Gulf Bank , Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.14. Kuwaiti Commercial Merging - Scenario (10)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	4363	37.0
Gulf Bank	1878	15.9
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.15. Kuwaiti Commercial Merging - Scenario (11)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	4650	39.4
Al-Ahli Bank of Kuwait	1487	12.6
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Commercial Bank of Kuwait, BKME

Table 5.16. Kuwaiti Commercial Merging - Scenario (12)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	4446	37.7
Commercial Bank of Kuwait	1691	14.3
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Al-Ahli Bank of Kuwait, BKME

Table 5.17. Kuwaiti Commercial Merging - Scenario (13)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	4259	36.1
Gulf Bank	1878	15.9
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

* Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, BKME

Table 5.18. Kuwaiti Commercial Merging - Scenario (14)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	4144	35.1
Commercial Bank of Kuwait	1691	14.3
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Burgan Bank, BKME

Table 5.19. Kuwaiti Commercial Merging - Scenario (15)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	3957	33.6
Gulf Bank	1878	15.9
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

* Commercial Bank of Kuwait, Burgan Bank, BKME

Table 5.20. Kuwaiti Commercial Merging - Scenario (16)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	3753	31.8
Gulf Bank	1878	15.9
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

* Al-Ahli Bank of Kuwait, Burgan Bank, BKME

Table 5.21. Kuwaiti Commercial Merging - Scenario (17)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	3569	30.3
Al-Ahli Bank of Kuwait	1487	12.6
Burgan Bank	1185	10.0
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Commercial Bank of Kuwait

Table 5.22. Kuwaiti Commercial Merging - Scenario (18)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	3365	28.5
Commercial Bank of Kuwait	1691	14.3
Burgan Bank	1185	10.0
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Al-Ahli Bank of Kuwait

Table 5.23. Kuwaiti Commercial Merging - Scenario (19)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	3063	26.0
Commercial Bank of Kuwait	1691	14.3
Al-Ahli Bank of Kuwait	1487	12.6
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Gulf Bank, Burgan Bank

Table 5.24. Kuwaiti Commercial Merging - Scenario (20)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	2959	25.1
Commercial Bank of Kuwait	1691	14.3
Al-Ahli Bank of Kuwait	1487	12.6
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

* Gulf Bank, BKME

Table 5.25. Kuwaiti Commercial Merging - Scenario (21)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	3178	27.0
Gulf Bank	1878	15.9
Burgan Bank	1185	10.0
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait

Table 5.26. Kuwaiti Commercial Merging - Scenario (22)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	2876	24.4
Gulf Bank	1878	15.9
Al-Ahli Bank of Kuwait	1487	12.6
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Commercial Bank of Kuwait, Burgan Bank

Table 5.27. Kuwaiti Commercial Merging – Scenario (23)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	2772	23.5
Gulf Bank	1878	15.9
Al-Ahli Bank of Kuwait	1487	12.6
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

* Commercial Bank of Kuwait, BKME

Table 5.28. Kuwaiti Commercial Merging - Scenario (24)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	2672	22.7
Gulf Bank	1878	15.9
Commercial Bank of Kuwait	1691	14.3
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

* Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.29. Kuwaiti Commercial Merging - Scenario (25)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	2568	21.8
Gulf Bank	1878	15.9
Commercial Bank of Kuwait	1691	14.3
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

* Al-Ahli Bank of Kuwait, BKME

Table 5.30. Kuwaiti Commercial Merging - Scenario (26)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks*	2266	19.2
Gulf Bank	1878	15.9
Commercial Bank of Kuwait	1691	14.3
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

* Burgan Bank, BKME

Table 5.31. Kuwaiti Commercial Merging - Scenario (27)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3569	30.3
Merged Banks (2)	2672	22.7
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Commercial Bank of Kuwait
(2) Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.32. Kuwaiti Commercial Merging - Scenario (28)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3569	30.3
Merged Banks (2)	2568	21.8
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Commercial Bank of Kuwait
(2) Al-Ahli Bank of Kuwait, BKME

Table 5.33. Kuwaiti Commercial Merging - Scenario (29)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3569	30.3
Merged Banks (2)	2266	19.2
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Commercial Bank of Kuwait
(2) Burgan Bank, BKME

Table 5.34. Kuwaiti Commercial Merging – Scenario (30)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3365	28.5
Merged Banks (2)	2876	24.4
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Al-Ahli Bank of Kuwait
(2) Commercial Bank of Kuwait, Burgan Bank

Table 5.35. Kuwaiti Commercial Merging - Scenario (31)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3365	28.5
Merged Banks (2)	2876	24.4
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Al-Ahli Bank of Kuwait
(2) Commercial Bank of Kuwait, BKME

Table 5.36. Kuwaiti Commercial Merging – Scenario (32)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3365	28.5
Merged Banks (2)	2266	19.2
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Al-Ahli Bank of Kuwait
(2) Burgan Bank, BKME

Table 5.37. Kuwaiti Commercial Merging - Scenario (33)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3063	26.0
Merged Banks (2)	3178	27.0
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Burgan Bank

Table 5.38. Kuwaiti Commercial Merging – Scenario (34)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3063	26.0
Merged Banks (2)	2772	23.5
BKME	1487	12.6
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Burgan Bank
(2) Commercial Bank of Kuwait, BKME

Table 5.39. Kuwaiti Commercial Merging - Scenario (35)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3063	26.0
Merged Banks (2)	2568	21.8
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Burgan Bank
(2) Al-Ahli Bank of Kuwait, BKME

Table 5.40. Kuwaiti Commercial Merging - Scenario (36)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2959	25.1
Merged Banks (2)	3178	27.0
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, BKME
(2) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait

Table 5.41. Kuwaiti Commercial Merging - Scenario (37)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2959	25.1
Merged Banks (2)	2876	24.4
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, BKME
(2) Commercial Bank of Kuwait, Burgan Bank

Table 5.42. Kuwaiti Commercial Merging – Scenario (38)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2959	25.1
Merged Banks (2)	2672	22.7
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, BKME
(2) Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.43. Kuwaiti Commercial Merging – Scenario (39)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3178	27.0
Merged Banks (2)	3063	26.0
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait
(2) Gulf Bank, Burgan Bank

Table 5.44. Kuwaiti Commercial Merging - Scenario (40)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3178	27.0
Merged Banks (2)	2959	25.1
BKME	1185	10.0
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait
(2) Gulf Bank, BKME

Table 5.45. Kuwaiti Commercial Merging – Scenario (41)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3178	27.0
Merged Banks (2)	2266	19.2
Burgan Bank	1878	15.9
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait
(2) Burgan Bank, BKME

Table 5.46. Kuwaiti Commercial Merging - Scenario (42)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2876	24.4
Merged Banks (2)	3365	28.5
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Burgan Bank
(2) Gulf Bank, Al-Ahli Bank of Kuwait

Table 5.47. Kuwaiti Commercial Merging - Scenario (43)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2876	24.4
Merged Banks (2)	2959	25.1
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Burgan Bank
(2) Gulf Bank, BKME

Table 5.48. Kuwaiti Commercial Merging – Scenario (44)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2876	24.4
Merged Banks (2)	2568	21.8
Gulf Bank	1878	15.9
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Burgan Bank
(2) Al-Ahli Bank of Kuwait, BKME

Table 5.49. Kuwaiti Commercial Merging - Scenario (45)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2772	23.5
Merged Banks (2)	3365	28.5
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, BKME
(2) Gulf Bank, Al-Ahli Bank of Kuwait

Table 5.50. Kuwaiti Commercial Merging - Scenario (46)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2772	23.5
Merged Banks (2)	3063	26.0
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, BKME
(2) Gulf Bank, Burgan Bank

Table 5.51. Kuwaiti Commercial Merging – Scenario (47)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2772	23.5
Merged Banks (2)	2672	22.7
Gulf Bank	1878	15.9
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, BKME
(2) Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.52. Kuwaiti Commercial Merging - Scenario (48)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2672	22.7
Merged Banks (2)	3569	30.3
BKME	1081	9.2
Total for All Commercial Banks	11792	100.0

(1) Al-Ahli Bank of Kuwait, Burgan Bank
(2) Gulf Bank, Commercial Bank of Kuwait

Table 5.53. Kuwaiti Commercial Merging - Scenario (49)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2672	22.7
Merged Banks (2)	2959	25.1
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

(1) Al-Ahli Bank of Kuwait, Burgan Bank
(2) Gulf Bank, BKME

Table 5.54. Kuwaiti Commercial Merging - Scenario (50)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2672	22.7
Merged Banks (2)	2772	23.5
Gulf Bank	1878	15.9
Total for All Commercial Banks	11792	100.0

(1) Al-Ahli Bank of Kuwait, Burgan Bank
(2) Commercial Bank of Kuwait, BKME

Table 5.55. Kuwaiti Commercial Merging - Scenario (51)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2568	21.8
Merged Banks (2)	3569	30.3
Burgan Bank	1185	10.0
Total for All Commercial Banks	11792	100.0

(1) Al-Ahli Bank of Kuwait, BKME
(2) Gulf Bank, Commercial Bank of Kuwait

Table 5.56. Kuwaiti Commercial Merging - Scenario (52)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2568	21.8
Merged Banks (2)	3063	26.0
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

(1) Al-Ahli Bank of Kuwait, BKME
(2) Gulf Bank, Burgan Bank

Table 5.57. Kuwaiti Commercial Merging - Scenario (53)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2568	21.8
Merged Banks (2)	2876	24.4
Gulf Bank	1878	15.9
Total for All Commercial Banks	11792	100.0

(1) Al-Ahli Bank of Kuwait, BKME
(2) Commercial Bank of Kuwait, Burgan Bank

Table 5.58. Kuwaiti Commercial Merging – Scenario (54)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2266	19.2
Merged Banks (2)	3569	30.3
Al-Ahli Bank of Kuwait	1487	12.6
Total for All Commercial Banks	11792	100.0

(1) Burgan Bank, BKME
(2) Gulf Bank, Commercial Bank of Kuwait

Table 5.59. Kuwaiti Commercial Merging – Scenario (55)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2266	19.2
Merged Banks (2)	3365	28.5
Commercial Bank of Kuwait	1691	14.3
Total for All Commercial Banks	11792	100.0

(1) Burgan Bank, BKME
(2) Gulf Bank, Al-Ahli Bank of Kuwait

Table 5.60. Kuwaiti Commercial Merging - Scenario (56)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	2266	19.2
Merged Banks (2)	3178	27.0
Gulf Bank	1878	15.9
Total for All Commercial Banks	11792	100.0

(1) Burgan Bank, BKME
(2) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait

Table 5.61. Kuwaiti Commercial Merging - Scenario (57)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	5056	42.9
Merged Banks (2)	2266	19.2
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank , Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait
(2) Burgan Bank, BKME

Table 5.62. Kuwaiti Commercial Merging - Scenario (58)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4754	40.3
Merged Banks (2)	2568	21.8
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank , Commercial Bank of Kuwait, Burgan Bank
(2) Al-Ahli Bank of Kuwait, BKME

Table 5.63. Kuwaiti Commercial Merging – Scenario (59)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4550	38.6
Merged Banks (2)	2772	23.5
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank , Al-Ahli Bank of Kuwait, Burgan Bank
(2) Commercial Bank of Kuwait, BKME

Table 5.64. Kuwaiti Commercial Merging – Scenario (60)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4363	37.0
Merged Banks (2)	2959	25.1
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, Burgan Bank
(2) Gulf Bank, BKME

Table 5.65. Kuwaiti Commercial Merging - Scenario (61)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4650	39.4
Merged Banks (2)	2672	22.7
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Commercial Bank of Kuwait, BKME
(2) Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.66. Kuwaiti Commercial Merging - Scenario (62)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4446	37.7
Merged Banks (2)	2876	24.4
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Al-Ahli Bank of Kuwait, BKME
(2) Commercial Bank of Kuwait, Burgan Bank

Table 5.67. Kuwaiti Commercial Merging - Scenario (63)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4259	36.1
Merged Banks (2)	3063	26.0
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, BKME
(2) Gulf Bank, Burgan Bank

Table 5.68. Kuwaiti Commercial Merging - Scenario (64)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4650	39.4
Merged Banks (2)	2672	22.7
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Commercial Bank of Kuwait, BKME
(2) Al-Ahli Bank of Kuwait, Burgan Bank

Table 5.69. Kuwaiti Commercial Merging - Scenario (65)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4446	37.7
Merged Banks (2)	2876	24.4
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Al-Ahli Bank of Kuwait, BKME
(2) Commercial Bank of Kuwait, Burgan Bank

Table 5.70. Kuwaiti Commercial Merging - Scenario (66)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4259	36.1
Merged Banks (2)	3063	26.0
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait, BKME
(2) Gulf Bank, Burgan Bank

Table 5.71. Kuwaiti Commercial Merging - Scenario (67)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	4144	35.1
Merged Banks (2)	3178	27.0
Total for All Commercial Banks	11792	100.0

(1) Gulf Bank, Burgan Bank, BKME
(2) Commercial Bank of Kuwait, Al-Ahli Bank of Kuwait

Table 5.72. Kuwaiti Commercial Merging - Scenario (68)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3957	33.6
Merged Banks (2)	3365	28.5
Total for All Commercial Banks	11792	100.0

(1) Commercial Bank of Kuwait, Burgan Bank, BKME
(2) Gulf Bank, Al-Ahli Bank of Kuwait

Table 5.73. Kuwaiti Commercial Merging - Scenario (69)
(Amount in Million KD)

Banks	Assets	%
National Bank of Kuwait	4470	37.9
Merged Banks (1)	3753	31.8
Merged Banks (2)	3569	30.3
Total for All Commercial Banks	11792	100.0

(1) Al-Ahli Bank of Kuwait, Burgan Bank, BKME
(2) Gulf Bank, Commercial Bank of Kuwait

Part 6

The GATS, Mergers and Consolidation within the Financial Sector in Kuwait

6.1. Introduction

International trade in goods is a relatively simple idea to grasp: a product is transported from one country to another. Trade in services, however, is quite different, because of the nature of the product. Telephone companies, banks, airlines and accountancy firms provide their services in quite different ways. The GATS annexes reflect some of this diversity; it deals with negotiations on individuals' rights to stay temporarily in a country for the purpose of providing a service. It specifies that the agreement does not apply to people seeking permanent employment or to conditions for obtaining citizenship, permanent residence or permanent employment. Since domestic regulations are the most significant means of exercising influence or control over trade in services, the agreement predicates that governments should regulate services reasonably, objectively and impartially. When a government makes an administrative decision that affects a service, it should also provide an impartial means for reviewing the decision (for example a tribunal). When two (or more) governments have agreements recognizing each other's qualifications (for example, the licensing or certification of service suppliers), the GATS stipulates that other members must also be given a chance to negotiate comparable pacts. The recognition of other countries' qualifications must not be discriminatory, and it must not amount to protectionism in disguise. These recognition agreements have to be notified to the WTO.

The financial system comprises several elements, including depositors, banks, entrepreneurs and regulators. Financial institutions operating in any country must follow some regulations enforced by the central monetary authority (CMA) to better serve the public and the national interest. The major objectives of regulating the banks are to reduce the risk of failure and to achieve some desired social goals. Bank regulations are designed to prevent commercial banks from becoming too risky and thus maintain public confidence in the country’s financial system. The economic argument for such regulation is that banking, by its very nature, is prone to market failure. The social costs

of such a failure exceed the financial costs of regulating the banking system. Regulations must be balanced and limited so that: (i) banks can develop new services according to the public demands, (ii) to ensure that the competition in financial services will remain strong (iii) to provide an adequate quantity & quality of service to the public, and (iv) to avoid waste of scarce resources. Regulations can increase customer confidence in banks, which in turn, may create greater customer loyalty toward banks.

6.2. Evolution of the World Trade Organization.

The World Trade Organization (WTO) is the only international body dealing with the rules of trade between nations. At its heart, are the WTO agreements negotiated and signed by the bulk of the world trading nations. These documents provide the legal ground-rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits. Although negotiated and signed by governments, the goal is to help producers of goods and services, exporter, and importers conduct their business.

The system's overriding purpose is to help trade flow as freely as possible, as long as there are no undesirable side effects, which in effect, means the partial elimination of obstacles. It also means ensuring that individuals, companies and governments know what the trade rules are around the world, and giving them the confidence that there will be no sudden changes of policy. In other words, the rules have to be "transparent" and predictable. Since, the agreements are drafted and signed by the community of trading nations, often after considerable debate and controversy; one of the WTO’s most important functions is to serve as a forum for trade negotiations. Another important side to the WTO work is dispute settlement. Trade relations often involve conflicting interests. Contracts and agreements, including those painstakingly negotiated in the WTO system, often need interpretation. The most harmonious way to settle these differences is through some neutral procedure based on an agreed upon legal foundation. That is the purpose behind the dispute settlement process written into the WTO agreements.

6.3. Principles of the Trading System

The WHO agreements are lengthy and complex because they are legal texts covering a wide range of activities. They deal with agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards, food

sanitation regulations, intellectual property, and much more. However, a number of simple, fundamental principles run throughout all of these documents. These principles form the foundation of the multilateral trading system.

6.3.1. Most Favored-Nation (MFN):

Under the WTO Agreements, countries cannot normally discriminate between their trading partners. Grant a country a 'special favor' (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members. This principle is known as most-favored-nation (MFN) treatment. It is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in the General Agreement on Trade in Services (GATS) (Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (Article 4), although in each agreement the principle is handled slightly differently. Together, those three agreements cover all three main areas of trade handled by the WTO.

Some exceptions are allowed. For example, countries within a region can set up a free trade agreement that does not apply to goods from outside the group. Alternatively, a country can raise barriers against products from specific countries that are considered to be trading unfairly. In addition, countries are allowed, in limited circumstances, to discriminate in the area of services. However, the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all of its trading partners, whether rich or poor, weak or strong.

6.3.2. National Treatment:

Treating foreigners and locals equally implies that imported and locally produced goods should be treated equally, at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. The principle of "'national treatment" (giving others the same treatment as one's own nationals) is also found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS), although, once again, the principle is handled slightly differently in each of these. National treatment only applies once a product; service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation

of national treatment even if locally produced products are not charged an equivalent tax.

6.3.3. Freer Trade: Incremental Steps Through Negotiation

Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities. Other issues such as red tape and exchange rate policies have also been discussed. Since the creation of the GATT in 1947-48, there have been eight rounds of trade negotiations. The first of these focused on lowering tariffs (customs duties) on imported goods. Following negotiations, industrial countries' tariff rates on industrial goods had fallen steadily to approximately 6.3% by the late 1980's. The negotiations had expanded to cover non-tariff barriers on goods, and to new areas such as services and intellectual property. Opening markets can be beneficial, but it also requires adjustment. The WTO agreements allow countries to introduce changes gradually, through "progressive liberalization". Developing countries are usually given longer to fulfill their obligations.

6.3.4. Predictability: Through Binding

Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition, choice and lower prices. The multilateral trading system is an attempt by governments to make the business environment stable and predictable. In the WTO, when countries agree to open their markets for goods or services, they "bind" their commitments. For goods, these bindings amount to ceilings on customs tariff rates.

Sometimes countries tax imports at rates that are lower than the bound rates. Frequently this is the case in developing countries. A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. One of the achievements of the Uruguay Rounds of multilateral trade talks, was to increase the amount of trade under binding commitments. In agriculture, 100% of products now have bound tariffs, and that has resulted in a substantially higher degree of market security for traders and investors. The system however, tries to improve predictability and stability in other ways as well. One-way is

to discourage the use of quotas and other measures used to set limits on quantities of imports, since administering quotas can lead to more red tape and accusations of unfair play. Another is to make countries' trade rules as clear and publicly "transparent" as possible. Many WTO agreements require governments to disclose their policies and practices publicly within the country or by notifying the WTO. The regular surveillance of national trade policies through the Trade Policy Review Mechanism provides further means of encouraging transparency, both domestically and at the multilateral level.

6.3.5. Promoting Fair Competition

The WTO is sometimes described as a "free trade" institution, but that is not entirely accurate. The system does allow tariffs, and in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair and undistorted competition. The rules on non- discrimination, MFN and national treatment are designed to secure fair conditions of trade. The same applies to those on dumping (exporting at below cost to gain market share) and subsidies. The issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade. Many of the other WTO agreements aim to support fair competition in agriculture, intellectual property and services, for example. The agreement on government procurement (a "plurilateral" agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of "government" entities in many countries and so on.

6.3.6. Encouraging Development and Economic Reform

It is widely recognized by economists and trade experts that the WTO system contributes to development. It is also recognized that the least- developed countries need flexibility in the time they take to implement the agreements. Actually, the agreements themselves inherit the earlier provisions of the GATT that allow for special assistance and trade concessions for developing countries. Over three quarters of WTO members are developing countries and countries in transition to market economies. During the seven and a half years of the Uruguay Round, over 60 of these countries implemented trade liberalization programs voluntarily. At the same time, developing countries and transition economies were much more active and influential in the Uruguay Round negotiations than in any previous round. This trend effectively killed

the notion that the trading system existed only for industrialized countries. It also changed the previous emphasis on exempting developing countries from certain GATT provisions and agreements. At the end of the Uruguay Round, developing countries were prepared to take on most of the obligations that are required of developed countries. However, the agreements did give them transition periods to adjust to the more unfamiliar and perhaps, difficult WTO provisions, particularly so for the poorest, “least-developed” courtiers. A ministerial decision adopted at the end of the round gives least developed countries additional flexibility in implementing WTO agreements. It predicates that more ‘developed’ or more affluent economies should accelerate implementing market access commitments on goods exported by the least-developed countries, and it also seeks increased technical assistance for them.

6.3.7. WTO and GATT: Are They The Same?

The General Agreement on Tariffs and Trade always dealt with trade in goods, and it still does. It has been amended and incorporated into the new WTO agreements. The updated GATT lives alongside the new General Agreement on Trade in Services (GATS) and Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The WTO brings the three together within a single organization, a single set of rules and a single system for resolving disputes. In short, the WTO is not a simple extension of GATT. It is much more. While GATT no longer exists as an international organization, the GATT agreement lives on. The old text is now called "GATT 1947". The updated version is called "GATT 1994". Moreover, GATT's key principles have been adopted by the agreements on services and intellectual property. These include non- discrimination, transparency and predictability.

6.4. International Trade and the Service Sector

6.4.1. The General Framework

The General Agreement on Trade in Services (GATS) is the first ever set of multilateral, legally enforceable rules covering international trade in services. It was negotiated in the Uruguay Round. Like the agreements on goods, GATS operates on three levels: the main text containing general principles and obligations; annexes dealing with rules for specific sectors; and individual countries' specific commitments to provide access to their markets. Unlike in goods, GATS has a fourth special element:

lists showing where countries are temporarily not applying the "most-favored-nation" principle of non-discrimination. These commitments, like tariff schedules under GATT, are an integral part of the agreement including the temporary withdrawals of the most-favored-nation treatment. A WTO Council for Trade in Services oversees the operation of the agreement. Negotiations on commitments in four topics have taken place after the Uruguay Round. A full new services round started in 2000. The GATS' 29 articles cover all service sectors; they contain the general obligations that all members have to apply. The basic principles related to the service sector are outlined below.

6.4.2. The Basic Principles Related to the Service Sector

- All services are covered by the GATS;
- Most-favored-nation treatment applies to all services, except for temporary exemptions;
- National treatment applies in the areas where commitments are made;
- Transparency in regulations, inquiry points;
- Regulations have to be objective and reasonable;
- International payments: normally unrestricted;
- Individual countries' commitments: negotiated and bound.
- Progressive liberalization: through further negotiations;
- Services supplied from one country to another (e.g. international telephone calls), officially known as "cross-border supply";
- Consumers or firms making use of a service in another country (e.g. tourism), officially known as "consumption abroad";
- A foreign company setting up subsidiaries or branches to provide services in another country (e.g. foreign banks setting up operations in a country), officially known as "commercial presence".

6.4.3. Principle of MFN as Applied to Services: (Favor one, favor all)

MFN means treating one's trading partners equally on the principle of non-discrimination. Under GATS, if a country allows foreign competition in a sector, equal opportunities in that sector should be given to service providers from all other WTO members. (This applies even if the country has made no specific commitment to provide foreign companies access to its markets under the WTO.)

MFN applies to all services, but some special temporary exemptions have been allowed. When GATS came into force, a number of countries already had preferential agreements in services that they had signed with trading partners, either bilaterally or in small groups. WTO members felt it was necessary to maintain these preferences temporarily. They gave themselves the right to continue giving more favorable treatment to particular countries in particular service activities by listing "MFN exemptions" alongside their first set of commitments. In order to protect the general MFN principle, exemptions could only be made once; nothing can be added to the lists. They are currently being reviewed as mandated, and will normally last no more than ten years.

6.4.4. Principle of National Treatment as Applied to Services:

National treatment means treating one's own nationals and foreigners equally. In services, it means that once a foreign company has been allowed to supply a service in one's country there should be no discrimination between the foreign and local companies. Under GATS, a country only has to apply this principal when it has made a specific commitment to provide foreigners access to its services market. It does not have to apply to national treatment in sectors where it has made no commitment. Even regarding the commitments, GATS has limits on national treatment. This contrasts with the way the national treatment principle is applied for goods, in that once a product has crossed a border and been cleared by customs it has to be given national treatment even if the importing country has not made any commitment under the WTO to bind the tariff rate.

6.4.5. Principles of Transparency as Applied to Services

The GATS requires that governments must publish all relevant laws and regulations. Governments, therefore, had to set up inquiry points within their bureaucracies by the end of 1997, so that foreign companies and governments can then use these inquiry points to obtain information about regulations in any service sector and they have to notify the WTO of any changes in regulations that apply to the services that come under specific commitments.

6.4.6. International Payments and Transfers:

Once a government has made a commitment to open a service sector to foreign competition, it must not normally restrict money being transferred out of the country as payment for services supplied ("current transactions") in that sector. The only exception is when there are balance-of-payments difficulties, and even then, the restrictions must be temporary and subject to other limits and conditions.

Individual Countries' Commitments on Market Access and National Treatment

Individual countries' commitments to open markets in specific sectors, and how open those markets will be, are the outcome of negotiations. The commitments appear in "schedules" that list the sectors that will be liberalized, and the extent of market access granted in those sectors (e.g. whether there are any restrictions on foreign ownership), and any limitations on national treatment (whether some rights granted to local companies will not be granted to foreign companies). So, for example, if a government commits itself to allow foreign banks to operate in its domestic market, that is a market access commitment. In addition, if the government limits the number of licenses it will issue, then that is a market-access limitation.

These clearly defined commitments are "bound": like bound tariffs for trade in goods, they can only be modified after negotiations with affected countries. Since, "unbinding" is difficult, the commitments are virtually guaranteed conditions for foreign exporters and importers of services and investors in the sector to do business. The lists of market access commitments (along with any limitations and expectations from national treatment) are negotiated as multilateral packages, although bilateral bargaining sessions are needed to develop the packages. The commitments therefore contain the negotiated and guaranteed conditions for conducting international trade in services. If a recorded condition is to be changed for the worse, then the government has to grant at least three months' notice and has to negotiate compensation with the affected countries. But the commitments can be revised and improved at any time. They will be subject to further liberalization through future negotiations already committed under the GATS. The Uruguay Round was only the beginning. The GATS requires more negotiations, the first to begin within five years. The eventual goal is to take the liberalization process further by increasing the level of commitments in schedules.

6.4.7. The Work Program and Current Negotiations

The WTO General Agreement on Trade in Services (GATS) contains separate mandates for a heavy work program covering a wide range of subjects. Work on some of the subjects started in 1995, as mandated, soon after the GATS came into force in January 1995. Work on other subjects, including the negotiations to further liberalize international trade in services, started in 2000, also as mandated. All of these subjects come under the current work program, some of which involve negotiations and some call for study and review. As yet, no deadlines have been set for conclusive work on any of these subjects, with one exception: the negotiations on safeguards.

6.4.8. Negotiations to Further Liberalize Trade in Services

Negotiations to further liberalize international trade in services started in early 2000 as mandated by the GATS (Article XIX). The negotiations are continuing actively with the full commitment of all members.

The first phase of the negotiations was concluded successfully in March 2001 when members agreed on the guidelines and procedures for the negotiations. Agreement on the guidelines marks the fulfillment of a key element in the negotiating mandate as laid down in the GATS. By agreeing to these guidelines, members have not only set the objectives, scope and method for negotiations in a clear and balanced manner, but also unequivocally endured some of the fundamental principles of the GATS, i.e. members' right to regulate and introduce new regulations on the supply of services in pursuit of national policy objectives; their right to specify which services they wish to open to foreign suppliers and under which conditions; and the overarching principle of flexibility for developing and least-developed countries. The guidelines, therefore, reflect great sensitivity toward public policy concerns in relation to important sectors such as health-care, public education and cultural industries, while stressing the importance of achieving higher level of liberalization and ensuring market access.

Since March 2001, the negotiations have moved into a more intensive phase of discussing specific proposals. So far, around l00 proposals have been submitted by 50 members covering a wide range of service sectors, the movement of natural persons and other issues such as the treatment of small and medium-sized enterprises, transparency of regulations, classification issues and MFN exemptions. Members have agreed to review progress in March 2002.

6.4.9. Work on GATS Rules (Articles X, XIII, and XV)

Negotiations started in 1995 and are continuing in the development of possible disciplines that are not yet included in the GATS: rules on emergency safeguard measures, government procurement and subsidies. Work so far has concentrated on safeguards, where members have agreed to conclude negotiations by March 2002. But the results will come into effect at the same time as the results of the current services negotiations, for which no deadline has been fixed as yet. Rules on safeguards will define the procedures and disciplines under which a member can introduce temporary measures to limit market access in situations of market disruptions.

6.4.10. Work on Domestic Regulations (Article VI.4)

Work started in 1995 to establish disciplines on domestic regulations, i.e. the requirements that Foreign Service suppliers have to meet in order to operate in a market. The focus is on qualification requirements and procedures, technical standards and licensing requirements. By December 1998, members had agreed on disciplines on domestic regulations for the accountancy sector. Since then, members have been engaged in developing general disciplines for all professional services and, where necessary, additional sectoral disciplines. All the agreed disciplines will be integrated into the GATS and become legally binding by the end of the current services negotiations.

6.4.11. Treatment of Autonomous Liberalization (Article XIX)

The negotiating guidelines and procedures agreed to by members in March, 2001 (see above) also stated that, based on the multilaterally-agreed upon criteria, credit shall be given in negotiations to autonomous liberalization efforts undertaken by members since previous negotiations, and that members shall endeavour to develop such criteria prior to the start of negotiations on specific commitments. Members are continuing their discussions on various issues including the relationship between credit and binding of commitments, how to assess the value of liberalization measures and hence the credit that will be granted, and the multilateral versus bilateral treatment of autonomous liberalization.

6.4.12. Assessment of Trade in Services (Article XIX)

Preparatory work on this subject started in early 1999. The GATS mandates that members conduct an assessment of trade in services with reference to the objectives of the agreement, including those related to increasing the participation of developing countries in trade in services. The negotiating guidelines also restate this mandate, making this a standing item on the members' agenda. Members have generally acknowledged that the dearth of statistical information and other methodological problems make it impossible to conduct an empirical assessment of trade in services. However, they are continuing their discussions with the assistance of several papers produced by the Secretariat.

6.5. The GATS Framework and the Liberalization of Financial Services

The GATS covers all measures taken by members affecting trade in services and all service sectors. The agreement is unusual in taking a wide view of what constitutes trade, and defines trade in services as the supply of a service through any of four modes.

Mode 1 deals with the cross-border supply of a service, which is analogous to international trade in goods, in that a product (service) crosses a national frontier. This category includes taking a loan or purchasing insurance coverage by a domestic consumer from a financial institution located abroad.

Mode 2 involves consumption abroad, including the movement of consumers to the territory of suppliers. The purchase of financial services by consumers while traveling abroad falls into this category.

Mode 3 is of crucial significance, and entails the commercial presence of a supplier of one member under the jurisdiction of another member. An example of this mode is a situation in which a foreign bank or other financial institution establishes a branch or subsidiary in the territory of a country and supplies financial services. By defining trade to include sales through commercial presence, the agreement includes in its domain foreign direct investment, which accounts for a large share of all service transactions, particularly in financial services.

Mode 4 covers the supply of services through the presence of natural persons of a member in the territory of another member. This mode relates both to independent service suppliers and to employees of juridical persons supplying services, covering potentially the presence, for instance, of independent financial consultants as well as the intra-corporate transfer of bank managers.

Certain GATS obligations apply across-the-board, while others depend on the sector-specific commitments assumed by individual members. The most important of the general obligations is the most-favored-nation (MFN) principle. The MFN principle prevents members from discriminating among their trading partners. While governments generally attach importance to MFN as a fundamental principle of general application, certain sectoral sensitivities that emerged in the Uruguay Round raised the specter of wholesale sectoral exclusions from the GATS as a means of avoiding the MFN rule. In order to prevent this, governments agreed to permit limited, and in principle temporary, exemptions to MFN under GATS. Such exemptions, however, had to be taken at the time the negotiations were concluded. In the case of financial services, a number of MFN exemptions had been maintained when the preceding round of negotiations were concluded in mid-1995, some of which reserved the right to apply reciprocity as a basis for granting market access. Among them was the MFN exemption of the United States, which reserved the right to discriminate between trading partners with respect to new entry or the expansion of existing activities, in order to "protect existing activities of United States service suppliers abroad and to ensure substantially full market access and national treatment in international financial markets." One of the key objectives of the extended negotiations was to achieve the removal of such exemptions and reach a full MFN-based result.

Article III on transparency is the second major obligation which applies across-the-board. Each member is required to publish promptly "all relevant measures of general application" (that is, measures other than those which involve only individual service suppliers) affecting trade in services. Members must also notify the Council for Trade in Services of new or changed laws, regulations or administrative guidelines that affect trade in services covered by their specific commitments under the agreement. By the end of 1996, each member should have established an enquiry point, to respond to requests from other members for information on these matters. This requirement is carried further as far as enquiries from developing countries are concerned. In this case, developed countries (and other members, if possible) are to establish contact points to which the service suppliers, not just the governments, of developing countries can turn for information about commercial and technical aspects of the supply of services, professional qualifications required, and the technology available.

6.6. Schedules of Specific Commitments

The liberalizing content of the GATS depends on the extent and nature of sector-specific commitments assumed by individual members. The core provisions of the GATS in this context relate to market access (Article XVI), national treatment (Article XVII) and additional commitments (Article XVIII). These provisions only apply to sectors explicitly included by a member in its schedule of commitments and there too, subject to the limitations that a member has scheduled. The inclusion in the GATS of the principle of "progressive liberalization" (Article XIX) reflects a collective acceptance that liberalization would be gradual. The focus of attention in the negotiations was the content of the national schedules of specific commitments, and the insurance that they were sufficiently improved to provide the basis for an agreement in which all members would participate.

It is worth emphasizing that the GATS commitments are guarantees and the absence of such guarantees need not mean that access to a particular market is denied. In fact, as will be shown later, there are several markets where conditions of access are more liberal than those bound under the GATS. The market access provision prohibits six types of limitations, unless they have been inscribed by a member in its schedule. These are: (a) limitations on the number of suppliers; (b) limitations on the total value of service transactions or assets; (c) limitations on the total number of service operations or on the total quantity of service output; (d) limitations on the total number of natural persons that may be employed; (e) measures which restrict or require specific types of legal entity or joint venture; and (f) limitations on the participation of foreign capital. The existence of any of these limitations has to be indicated with respect to each of the four modes of supply, described above. As discussed in more detail below, the use made of these limitations, particularly (a) and (f), is one of the most important elements determining the economic implications of commitments. It should, of course, be remembered that governments also have the right not to inscribe a sector at all in their schedules of specific commitments, so that the quality of the market access commitment only becomes important once a government has decided to make an entry in its schedule.

National treatment is defined under Article XVII in the traditional GATT manner, as treatment no less favorable than that accorded to domestic homologues, in this case services or service suppliers. In contrast to the GATT approach, however, members may inscribe limitations on national treatment in their schedules, with respect

to each of the four modes of supply, as in the case of the market access provision. The main reason why negotiators eschewed the GATT approach of making national treatment an overarching principle of general application, as they did with MFN, is that granting market access with full national treatment is the equivalent of establishing free trade. Governments wanted the option of adopting a more gradual and conditioned approach to opening up their markets, by making national treatment something to be granted, denied or qualified, depending on the sector and the signatory concerned.

Article XVIII offers the opportunity for signatories to negotiate additional commitments not dealt with under the market access and national treatment provisions of Article XVI and Article XVII. Additional commitments must offer more open access. They cannot establish additional market barriers by detracting from MFN or from market access or national treatment commitments. Additional commitments could apply to such matters as qualifications, standards and licensing. Limited use was made of this option in the Uruguay Round negotiations. Other provisions of the GATS apply when specific commitments have been made by a member, including provisions relating to notification requirements and the behavior of monopolies and exclusive service suppliers.

A number of countries have undertaken commitments in financial services using the 'Understanding on Commitments in Financial Services'. Among the countries studied were Nigeria, Turkey, Bulgaria, Czech Republic, Hungary, Slovak Republic and Sri Lanka (for banking and other financial services, excluding insurance). It also contains a commitment not to discriminate in the government procurement of financial services and to permit an established foreign financial service supplier to offer any new financial services. Other important provisions include a commitment not to take measures that prevent transfers of information or the processing of financial information, to endeavour to limit the adverse affect on foreign services suppliers of certain non-discriminatory measures and to provide them national treatment in certain areas. Members who use the Understanding to schedule commitments are, however, not obliged to accept all its liberalizing elements and several have scheduled limitations which run counter to its provisions.

6.7. GATS Commitments and Wider Policy Concerns

What are the implications of the GATS commitments for the broader policy framework relevant to the financial services sector? At least three areas of policy need

to be considered: prudential regulation, macroeconomic policy management, and other domestic economic interventions. A key question is whether there is reason for members to hold back on commitments in order to retain the freedom to follow certain domestic policy objectives. The following discussion shows that commitments under the GATS need not compromise the ability of governments to pursue sound macroeconomic and regulatory policies.

First consider prudential regulation. In financial services, specific commitments are made in accordance with the Annex on financial services which complements the basic rules and definitions of the GATS taking into account the specific characteristics of financial services. Of particular significance is paragraph 2(a) which states that: "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system." The same paragraph goes on to say that where prudential measures do not conform to other provisions of the GATS, they must not be used as a means of avoiding commitments or obligations under the agreement. Prudential measures need not be inscribed in members' schedules of specific commitments, as they are not regarded as limitations on market access or national treatment. This language differs from that in Article XIV dealing with General Exceptions in that it does not require that the measures be necessary to achieve the stated objectives. It would, therefore, seem that members have considerable freedom in their choice of prudential measures. Measures consistent with this provision would seem to include capital adequacy ratios, restrictions on credit concentration or portfolio allocation, and disclosure and reporting requirements, as well as licensing criteria imposed on financial institutions which are not more burdensome than necessary to ensure the solvency and the healthy operation of those institutions.

Consider now macroeconomic policy in general. When a central bank conducts open market operations, for example, conditions in the financial sector could be affected through the impact of such interventions on the money supply, interest rates or exchange rates. It is notable that services supplied in the exercise of governmental authority, including activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies, are excluded from the scope of the GATS. Furthermore, a wide range of measures for

macroeconomic management, such as reserve requirements on banks, could presumably be justified as measures to ensure the integrity and stability of the financial system under the terms of the Annex on Financial Services.

Article XI of the GATS is the key provision covering international payments and transfers. It stipulates that, except under circumstances envisaged in Article XII (described below), a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments (Article XI:1). Furthermore, Article XI:2 provides that: "Nothing in the GATS affects the rights and obligations of the Members of the International Monetary Fund (the Fund) under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that a member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the fund. Footnote 8 to Article XVI would, however, seem to narrow the range of circumstances in which a Member is obliged to allow capital transactions. This footnote states that if a member undertakes a market access commitment in relation to the cross-border supply of a service and if the cross-border movement of capital is an essential part of the service itself, that member is committed to allow such movement of capital. If a member undertakes a market access commitment in relation to the supply of a service through commercial presence, that member is committed to allow related inflows of capital into its territory. Thus the footnote would seem to relieve members of obligations with respect to capital flows related to consumption abroad, and with respect to capital outflows related to commercial presence. Although these provisions apply to all services, they are particularly relevant in the context of financial services, since a commitment to liberalize market access in financial services could be undermined without a concomitant obligation to liberalize associated capital flows.

Notwithstanding the obligations in Article XI and footnote 8 to Article XVI, a member may impose restrictions on current or capital transactions in certain circumstances. First, in the event of serious balance-of-payments and external financial difficulties or threat thereof, Article XII permits a member to introduce restrictions of a temporary nature on trade in services for which it has undertaken specific commitments. Such restrictions could include those on international payments or transfers related to a member's commitments. Article XII stipulates that the restrictions shall not discriminate among members, shall be consistent with the articles of agreement of the fund, and shall

be temporary and be phased out progressively as the situation improves. The procedures for invoking such measures involve notification and consultation with other members, with the fund playing a crucial role in the process of establishing the legality of such measures under the GATS. Secondly, the language of paragraph 2 of the Annex on Financial Services would also seem to allow restrictions on international transactions if they were needed to ensure the integrity and stability of the financial system.

Finally, consider the other domestic regulations that governments maintain, which are not prudential in nature, but which nevertheless can affect the conditions of operation and competition in a market. Such measures could include, for example, a requirement to lend to certain sectors or individuals. Such lending might also be mandated on the basis of preferential interest rates. Even though such measures may not be the most efficient means of achieving particular objectives, these policies are not necessarily subject to commitments made under the GATS. Whether they are or not depends on a judgment as to whether they constitute limitations on market access or national treatment. If they are neither discriminatory nor intended to restrict the access of suppliers to a market, then such non-prudential domestic regulatory measures would normally fall within the auspices of GATS Article VI disciplines.

Article VI seeks to ensure that domestic regulations involving qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade. Article VI requires that these elements of domestic regulation are based on transparent and objective criteria, are not more burdensome than necessary to ensure the quality of the service, and in the case of licensing procedures are not in themselves a restriction on the supply of a service. Article VI does not, however, question the right of members to pursue public policy objectives in respect of which qualification requirements and procedures, technical standards, and licensing requirements are applied. There has often been concern about the potential for selective servicing by foreigner suppliers. It is always feared and cautioned that the latter will only service profitable market segments and that the resulting under-provision of retail banking in rural areas, for example, could then have detrimental effects of imbalanced development on the economy. It would seem possible under GATS to impose certain requirements, such as universal service obligations, as part of licensing requirements provided these do not discriminate between foreign and domestic financial institutions. Social objectives could then be met without sacrificing the efficiency benefits of competition.

6.8. Kuwait Banking Regulation and Supervision Affecting Operations, Mergers and Acquisitions

6.8.1. Institutional Framework for Banking Supervision

The Central Bank of Kuwait (CBK) is empowered to regulate and supervise the country's financial system. CBK's basic authority comes from "Law 32 of 1968 Concerning Currency, the Central Bank of Kuwait and the Organization of Banking Business". CBK issues currency, treasury bills and bonds on behalf of the government. Other authorities include making loans or advances, in emergency cases, through current accounts for a period not exceeding six months against such collateral, as CBK may consider adequate and issuance of negotiable bills, and transacting commercial papers with maturities of up to one year. The representative of the Ministry of Finance on the board of directors may request the suspension of any resolution issued by the board relating to monetary and credit policy for referral of the minister of finance. CBK acts as lender of last resort to the banking system. Its supervision covers all seven commercial banks operating in Kuwait, two specialized banks, and investment and exchange companies (including 12 investment companies whose operations are based on Islamic Sharia), which were brought under CBK's direct supervision in 1987 and 1984, respectively. However, CBK does not act as lender of last resort nor does it provide investment companies with funding facilities, as is the case with the banks. Any provision of necessary support would be the responsibility of the shareholders of the institution concerned. Kuwait Finance House (KFH), the country's first and sole Islamic financial institution which engages in the full range of banking activities, is not supervised by CBK but instead reports to the ministry of finance. However, KFH is understood to follow, on a voluntary basis, CBK guidelines. In this regard, the central bank has drafted a law for the supervision and regulation of Islamic banks which is intended to be added to Chapter III of Law 32 of 1968. This section contains 14 articles relating to definitions and procedures of establishing Islamic banks and subjecting the banks to the control of CBK. This draft law, and a slightly different version proposed by a group in the parliament, has been before parliament since 1998. There are renewed hopes that the amended law will be passed this year.

6.8.2. Consolidation Practices for Supervisory Purposes

CBK supervises domestic banks both on an individual and a consolidated basis. For consolidation, all activities of overseas branches and subsidiaries are included as an integral part of the head office's activities. Banks must submit to CBK within three months from the end of their financial year their balance sheet and profit and loss account. Until these accounts are approved by CBK, they cannot be released. Foreign bank branches must maintain independent accounts for all their operations in Kuwait, including balance sheet and profit and loss accounts. The Ministry of Commerce and Industry has ruled that all Kuwaiti joint stock companies (which include banks) must produce audited accounts that meet International Accounting Standards. This came into force with the results for the financial year ending December 1991.

6.8.3. Modalities for Verification, Examination and Inspection

CBK can, at any time, inspect institutions that are under its supervision. Bank examination is performed on and off-site. The on-site inspections are performed on a regular basis at a bank's head office and at select branches. These inspections involve a thorough and systematic review of a bank's accounting and internal control procedures and systems. Central bank staff may ask any member of the board of directors or any official of the bank or institution to submit and give such data and information they deem necessary for the purpose of conducting their examination. A comprehensive report is prepared and sent by the governor to the bank's chairman of the board of directors. The report includes recommendations on appropriate remedial action to be taken, where necessary. In addition to the full inspections, the CBK also conducts special focus visits that concentrate on a particular aspect of a bank's operations. The overall objective is to evaluate the financial condition of a bank through the use of the CAMEL model.

The off-site function focuses on both quantitative and qualitative factors. Supervision is conducted by analyzing monthly statistical returns. The information required includes portfolio exposure by economic sector, volume of classified loans, large exposures to individual customers, liquidity profiles, foreign exchange operations and projected balance sheets. Information provided remains confidential but sector statistical data is published in consolidated form. CBK relies, when needed, on the work of the external auditors to supplement its supervisory duties. External auditors appointed by banks must be approved by CBK. Since 1994 banks have been asked to

appoint two external auditors approved by CBK from separate auditing offices from an approved list. All the firms on this list are associated with large international practices.

In April 1995, CBK issued instructions to the banks' auditors to evaluate their internal auditing systems and provide the central bank with a report. This was followed up with another circular issued in November 1997 requesting the banks to establish specific guidelines with the aim of applying sound internal control systems.

6.8.4. Main Entry Requirements

No banking institution is allowed to start operations until it has been registered in the Register of Banks at CBK. Registration or refusal of registration is affected by a decision of the minister of finance on the recommendation of CBK's board of directors. Banking business may only be practiced by institutions set up in the form of public shareholding companies. This has to date effectively prevented foreign-owned institutions from establishing a presence in Kuwait. Since 1994, foreign ownership has been permitted to the extent of 40% of a bank's capital. Until 2001, no foreign investors had taken a stake in a local bank. However during Q1 2001, Ahli United Bank of Bahrain acquired a 15% stake in Bank of Kuwait and The Middle East (BKME). An outline Foreign Investment Law has now been passed. Although detailed measures are still with parliament, this law may allow the eventual entry of foreign banks.

According to "Law No. 32 of 1968", the capital of any bank shall not be less than KWD 3 million although in practice the required level would be much higher. Since 1992, all Kuwaiti banks were required to achieve capital ratios in excess of 8% under the Capital Adequacy Directive set up by the Basle Committee. In April 1997, CBK raised the minimum requirement to 12%. In 1992, the law was amended and regulations concerning directors and management of Kuwaiti banks were toughened, laying down minimum standards of experience and education. This is in addition to the existing legal requirements which state that no person who has been convicted of an offence involving dishonourable conduct or dishonesty, or who has been declared bankrupt or has suspended payment, may be a member of the board of directors or a manager of any bank.

6.8.5. Supervisory Control on Mergers, Participations in Credit Institutions and Ownership of Banks

Mergers, take-overs, acquisitions or participations in other banks require CBK's approval. CBK's policy with regard to mergers is that it encourages such moves in principle but it has not provided banks with incentives to merge. CBK states that it is not willing to force mergers upon the banks and that it should be up to the banks' shareholders to make such strategic decisions. Given the current ownership and strong capital ratios of Kuwaiti banks, it is unlikely that mergers will occur in the short term despite occasional rumours to the contrary.

6.8.6. Prudential Regulations on the Scope of Banking Activity

Banks must not engage in trade or industry, or own goods unless such goods have been acquired in settlement of debts due to them. The bank shall sell such goods within one year from the date of acquisition.

Banks must not purchase any real estate other than that required for conducting their business or accommodating their staff, unless such property has been acquired in settlement of debts. In the latter case, the bank shall sell real estate within a period not exceeding three years. The said period, however, may be extended by a decision of the board of directors of the central bank.

Banks must not own or deal in their own shares unless such shares have been acquired in settlement of debts due to them, and provided that they sell them within two years from the date of acquisition.

Banks may purchase, for their own account, shares of other commercial companies within a limit of 50% of the bank's own funds. This limit may not be exceeded without prior approval by the central bank.

Banks may own shares or other assets held with them in settlement of debts due to them. In such cases the bank shall dispose of these assets within two years from the date of acquisition.

6.8.7. Portfolio Requirements

The ratio of credit concentration to any single customer or customer group was raised from 10% (initially set in November 1993) to 15% in April 1995. CBK has also issued rules to be observed by banks in extending credit facilities to members of their boards of directors in order to ensure that these directors are not granted preferential

advantages due to their posts. In December 1999, the CBK required greater disclosure on exposure to related parties.

In June 1993, CBK issued instructions with regard to rules and regulations governing the extension of consumer loans. These instructions define the concept of a consumer loan and set out general rules and regulations that should be followed by banks and investment companies when extending such loans, including data on these loans that should be reported periodically to CBK. The maximum repayment period of consumer loans was extended to three years (from two previously) in April 1997. At the same date, CBK decided that all personal loans should be in the form of term loans, except for the margin loans extended for the purchase of securities.

A circular dated September 1996 raised the minimum limit of both the term loans and loans extended in the form of discounted commercial papers denominated in Kuwaiti Dinars to 75% from 60% of the total cash facilities. In order to curtail the rapid growth in consumer lending in the late 1990s, CBK adopted a rule stipulating that, a bank must restrict consumer loans to 10% of customer deposits. In March 2000, this regulation was refined in several ways. Firstly the basic ratio was raised to 12%. Secondly, banks were allowed to include as customer deposits, those from non-bank financial institutions (deposits from banks, investment companies and government are still excluded). Lastly, banks were also allowed to count as deposits, for the purposes of this calculation, 30% of any bonds in issue. There is a KWD 70,000 cap on consumer loans to a single obligor. This cap operates as an aggregate limit and covers all loans from both banks and non-banks. A credit bureau is being introduced. This will collate data from all lenders on consumer exposures, including commercial lenders such as sellers of consumer durables.

In May 1997, CBK asked the banks to suspend the extension of any new credit facilities for trading on the Kuwait stock exchange (KSE) in the form of margin lending, except for the purpose of purchasing government-owned shares in certain Kuwaiti companies (i.e. privatization). Banks were asked to reduce their outstandings, so that such balances do not exceed the lesser of 10% of the total value of domestic lending or 25% of a bank’s capital and reserves. Moreover, banks were required to monitor such credit facilities strictly and to ensure that facilities were being used properly in accordance with their designated purposes. However, in February 1999, CBK issued a circular allowing banks and investment companies to resume margin lending but within the 10% and 25% limits above.

According to a circular issued in December 1999, banks are to present to CBK at the end of each fiscal year the justifications for holding their own shares. The circular also requires banks that want to acquire a portion of their own shares to submit a complete study highlighting the importance of such acquisitions; a quarterly statement indicating the number of such shares purchased or disposed of and the value of the corresponding transactions. A June 1998 circular instructs local banks to include in their credit risk centralization data their credit card facilities exceeding KWD10,000 effective August 1998. Two major banks only are allowed to enter into derivative products but such practice is generally discouraged by CBK. Currently, the central bank is in the process of developing rules for the regulation of Smartcards which are in line with internationally adopted practices, and are expected to play an increasing role in the banks' activities throughout the GCC.

6.8.8. Prudential Control on Liquidity

The maximum permitted aggregate foreign exchange position is 15% of a bank's capital base. A decision issued in January 1995 abrogated the minimum interest rates on both deposits and savings accounts. Similarly, CBK abolished the maximum limits of charges and commissions collected by banks when rendering banking services. A circular released in October 1997 requires banks to maintain 20% of their customer KWD deposits in the form of local treasury bills and bonds. A mis-match approach has been implemented in 1997. This approach measures the net difference between cash inflows and outflows for each time bucket. CBK may impose tighter gap limits on any bank in light of its financial position. The aim is for the banks to adopt sound internal procedures and controls for liquidity management, including the implementation of asset liability management committees and the availability of efficient computer systems.

6.8.9. Capital Adequacy

In 1992, all Kuwaiti banks were required to achieve capital ratios in excess of 8% under the risk assets ratio system set up by the Basle committee. In April 1997, CBK lifted the minimum requirement to 12%. Some time ago, CBK has amended capital adequacy requirements to take into consideration market risk. Under the draft regulation that was issued in 1999, a bank is required to report its net effective position, after taking into account the effect of its trading and non-trading activities (comprising

transactions in derivative instruments, exposure to assets in the equities, money, capital and commodities markets and the aggregate net foreign-currency position). A bank must assess the values at risk pertaining to these markets and the amount of capital that it must put aside to support such activities. Banks began reporting such data in 2000 on an experimental basis pending the final draft of the regulations, which were implemented in Q1 2001.

6.8.10. Provisions for Bad and Doubtful Assets

In December 1996, CBK introduced amended rules concerning classification of credit facilities. The amount of provisions depends on the extent that loan-servicing payments are past due irrespective of all other factors related to customer conditions. Past due loans for more than 90 days require 20% provision. For loans past due more than 180 days the percentage increases to 50% while any loan past for more than 365 days requires 100% provision. The banks' provisioning requirements are evaluated by the CBK on a quarterly basis. Interest on loans that are 90 days or more overdue is not recognized as income. In addition to specific provisions, banks are required to maintain a general provision of 2% of all regular cash and non-cash facilities. Banks have been given until year-end 2000 to fully meet this regulation but nearly all have already met the requirement.

Banks have also been required to create an internal committee comprising qualified professionals to study and evaluate existing credit facilities in order to identify any abnormal situation and difficulties associated with a customer's position and which may entail classifying the debt as irregular and determining a suitable provision level. This committee, which is to meet on a regular basis, must scrutinize the positions of those customers whose irregular balances exceed 25% of their total debt so as to assess whether further provisioning is required. Moreover, the central bank has encouraged banks to significantly upgrade their risk assessment and management functions in recent years and most banks now have dedicated departments for this task.

6.8.11. Handling Distressed Banks

CBK provides lender of last resort facilities to all local banks it supervises. In a stress situation at a particular institution, or if the sector as a whole experiences liquidity pressure, the central bank would provide assistance through the rediscounting of commercial papers (with a maximum maturity date of one year). Support may also be

extended through the rediscounting of GDBs and loans and advances in emergency cases for a period not exceeding six months, against such collateral as CBK may consider adequate.

CBK's track record in supporting the banking system has thus far been exemplary. The central bank intervened in 1982 as a result of the crash of the informal stock exchange, providing relief to the banks and debtors alike through the placement of interest free deposits and the introduction of the bad debt settlement program in 1986. The monetary authorities supported the banking sector again after the Gulf war through the implementation of Law 32 of 1992, empowering the central bank to purchase all the banks' domestic non-performing loans in exchange for GDBs. CBK is unlikely to reduce its support to the banking sector if it were to face a systemic crisis. This said, however, CI understands that CBK is prepared to ease over time its unconditional support to the local banks. The CBK wishes to avoid complacency among shareholders and management, which have always looked for, and received, support from the authorities in times of hardship. CBK has steadily tightened its regulatory and supervisory functions over the last few years. This has helped to ensure that the banks are managed more professionally than in the past and this has considerably reduced the risk of bank failure.

6.9. Conclusion

Changes in financial markets have had a significant effect on the way banks do business. To allow banks to compete and keep pace with these changes, the CMA needs to develop and implement a plan for regulatory reform that is flexible and adaptable to both past and future changes in financial markets. In recent years, the CMA of GCC countries have made many regulatory changes in order to achieve certain economic and social goals. The CMA of Bahrain, Kuwait, Saudi Arabia and Oman have strengthened prudential norms in recent years. Asset classification and provisioning charges have moved closer to international standards. Banks are required to maintain capital to risk weighted assets ratios of 8% required by the BIS. Commercial banks use IAS. Overall, the CMA in these countries is very active in terms of supervising and monitoring their regulations on banking sectors. However, unlike the developed countries they have occurred in a slow process. One of the major obstacles to achieving consensus on a plan for reform is that the authorities of the GCC countries often lose sight of the common goals.

Assessment of the 50 Largest Bank Mergers

Probably a success	Neutral	Probably a failure
▪ ABN-Amro ▪ ASS. First Cap.-His.Avca Fin. ▪ Ass.Generali-B.della Swizzera ▪ B.de Santander-B. Central Hispano ▪ Banco de Santander-Banesto ▪ Bayer. Vereinsbank-Hypobank ▪ BCP-BPA ▪ Chase-Chemical ▪ Cred. Italiano-Credito Romagnolo ▪ Deutsche Bank-Bankers Trust ▪ Dt.Verkehrsb.-Long Term Credit ▪ Lloyds-TSB ▪ Nordbanken-Merita ▪ Star Bank Corp.-Firstar ▪ Travelers-Citicorp	▪ ABN/Amro-Banca Real ▪ Ambroveneto-CARIPLO ▪ B.de Bilbao-Banco de Vizcaya ▪ B.Bilbao Vizcaya-B.Excel Economica ▪ Bank Austria-Creditanstalt ▪ Bank of Tokyo-Mitsubishi Bank ▪ CCB-CLF ▪ Credito Italiano-Unicredito ▪ Credit Suisse-Winterthur ▪ Dresdner Bank-Kleinwort Benson ▪ First Bank-US Bancorp ▪ IB San Paolo di Torino-IMI ▪ ING-Barings ▪ Merrill-MAM ▪ Morgan Stanley-Dean Witter ▪ Nat. Australia-Michigan National ▪ Nations Bank-Bank America ▪ Norwest-Wells Fargo ▪ Rabobank- Robeco ▪ SBC-UBS ▪ Societe Generale –Credit du Nord ▪ Travelers-Salomon Broths.	▪ B.Central-B.Hisp.Americano ▪ B. di Roma-B.Santo Spirito/Cassa di Roma ▪ Banc One-First Chicago ▪ Credit Agricole-Banque Indosuez ▪ First Union –Core States ▪ Fleet Fin.Corp.-Sanwa Bus.Cr. ▪ Monte del Paschi di Siena-Banca Agricola Montava ▪ Realkredit-BG Bank ▪ St.George Bank-Advance Bank Australia ▪ Sun Trust-Crestar Fin.Corp. ▪ Washington Mutual-HF Abmanson ▪ Wells Fago-First Interstate

Source :Bain &Cy.

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Appendix: Summary and Bibliography of Studies

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Studies of the Effect of Bank Mergers, 1980-93

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Frieder and Apilado (1983)	1973–77	106	106 affiliates of four large BHCs in a large southern state. Lead banks of the BHCs are excluded. Unique sample and data that cannot be replicated	Unique methodology involving hypothetical measures of key variables. Compares actual earnings per share of a BHC that made an acquisition with hypothetical earnings per share of the BHC constructed on the assumption that an acquisition did not take place. Affiliates of the BHCs have been affiliated for one year or more, providing varying post acquisition periods. Uses differences between hypothetical and actual adjusted net income measures to estimate magnitude of any merger effect. Analyzes effect on combined entity. Presumably the affiliates analyzed were established banks acquired by the BHC rather than de novo banks formed and ‘‘acquired’’ by the BHC, but this is not clear
Lobue (1984)	Not noted	37	Stock of acquiring firms is traded on the NYSE or OTC. Six of the acquisitions are of non bank firms. Sample includes only acquiring firms	Event study. Analyzes abnormal returns on the stock of the acquiring firm relative to the market return. Calculation of abnormal returns is based on a log-transformed standard market model estimated over an unspecified period. Abnormal returns relative to the market are analyzed for 24 months before, to 18 months after, the effective acquisition date. Returns are analyzed for different groupings of firms based on size of merging firms, state branching laws, etc.
Desai and Stover (1985)	1976–82	18	Acquiring firms are identified from Moody's Bank and Finance Manuals and other sources and are listed on the CRSP daily return files. They have made no acquisitions for at least two years before 1976. Analysis focuses only on the acquiring firm	Event study. Analyzes cumulative abnormal returns, relative to the market, for a two-day period including the event day and one day after. Returns are measured only for the acquiring firm. Analysis is based on stock market returns to the market and the acquiring firm using a standard market model estimated over the period from 270 days to 31 days before announcement date. Analyzes stock market reaction to both the announcement and Federal Reserve approval

Note: In this table, the studies appear in chronological order by date of publication. Two works not covered by the present study analyze the efficiency effects of simulated rather than actual mergers or merger announcements. See Donald T. Savage, ‘‘Mergers, Branch Closings, and Cost Savings’’ (Board of Governors of the Federal Reserve System, 1991); and Sherrill Shaffer, ‘‘Can Mega mergers Improve Bank Efficiency?’’ *Journal of Banking and Finance,* vol. 17 (April 1993), pp. 423–36. Savage finds declines in efficiency based on large in-market mergers; Shaffer finds that about one-half of simulated large mergers would reduce efficiency and the other half would increase efficiency

AMEX American Stock Exchange
BHC Bank holding company
CRSP Center for Research on Security Prices
FDIC Federal Deposit Insurance Corporation
NASDAQ National Association of Securities Dealers Automated Quotes
NYSE New York Stock Exchange
OLS Ordinary least squares
OTC Over the counter
S&P Standard and Poor's
WSJ *Wall Street Journal*

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Hypothetical effect of mergers on earnings per share	Hypothetical measures of earnings per share and adjusted net income, with and without acquisition	Univariate *t* tests	BHC bank affiliates have a positive effect on hypothetical BHC profitability each year after acquisition, from one year to eight or more years
Wealth effects	Abnormal returns on stock	Residual analysis	Acquiring firms, on average, have positive cumulative abnormal returns
Wealth effects	Abnormal returns on stock	Residual analysis	Acquiring firms have positive significant cumulative abnormal returns on the announcement day and one day after The size of the target relative to the acquirer does not affect the return to the acquirer Acquiring firms have positive significant cumulative abnormal returns during the 2-day event window associated with approval of the acquisition by the Federal Reserve Board

1. For event studies, may include merger announcements for mergers never consummated.
2. In event studies, a standard market model refers to the regression model, $R_{it} = a_i + b_i R_{mt}$, used to estimate the coefficients, *a* and b, needed to compute the abnormal return, $AR_{it} = R_{it} - (a_i + b_i R_{mt})$. See text p. 4 for details.
3. Measures that reflect performance in terms of profitability, efficiency, or abnormal returns to shareholders. Does not include measures such as loans/assets or capital/assets.
4. In event studies, residual analysis and prediction error analysis are treated as synonymous.

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Pettway and Trifts (1985)	1972–81	11	Merged firms are all failing banks that the FDIC assisted in a purchase and assumption merger. Acquiring firms are listed on a major exchange or OTC, are on CRSP tapes, and are frequently traded. Sample includes only the acquiring firms	Event study. Analyzes abnormal returns on the stock of the acquiring firm relative to the market. Analysis covers from ten days before merger to 50 days after. Prediction errors or abnormal returns for individual firms are calculated using a standard market model estimated over the period from 60 days to ten days before merger. (The merger and its announcement occur simultaneously in FDIC-assisted mergers.) The residuals are not cumulated by the usual cumulative abnormal returns method. Instead, an average geometric residual return is calculated
Rhoades (1986)	1968–78, even years	413	Banks acquired by BHCs. Also includes about 3,600 no acquired banks located in the same markets as acquired banks and with operations in no other markets	Analyzes operating performance changes. Compares average performance during three years before with fourth–sixth years after acquisition of acquiring and nonacquiring firms. Analysis focuses on the acquired bank rather than the combined entity both before and after acquisition
De and Duplichan (1987)	1982–85	28 (22 targets and 24 bidders)	Strictly interstate mergers that were ultimately consummated. Bidders and targets have stock traded on a major exchange or OTC and have more than $100 million in assets. Acquisition announcements by grand fathered banks or BHC are excluded	Event study. Analyzes abnormal and cumulative abnormal returns, relative to the market, of acquiring and acquired firms for up to 30 days before and after the announcement date. Analysis is based on a standard market model estimated with *weekly* return data for 52 weeks before the announcement date. Return data are from CRSP, the S&P Stock Price Record, and the S&P 500 composite index

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Wealth effects	Average geometric residual return	Residual analysis	Acquiring firms have positive significant average abnormal returns during ten days before merger Negative significant average abnormal returns are experienced during 50 days after merger for 11 FDIC-assisted purchase and assumption mergers; positive returns occur for three days after merger
Performance changes	Net income/total assets Non-interest expenses/ total assets	Multiple regression (staff study) Profit analysis (chapter)	Efficiency does not improve after merger com-pared to that of non-acquired firms Profit rates do not improve after merger relative to those of non-acquired firms Before merger the profitability and efficiency of acquired firms are no different from those of non merging firms. Growth of market share of merged firm does not improve after merger when compared with that of non-acquired firms
Wealth effects	Abnormal returns on stock	Residual analysis	Neither acquiring nor acquired have significant abnormal returns during the 30 days before announcement or after

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
James and Wier (1987a)	1973–83	79	19 mergers resulting from FDIC failed-bank auctions in which the winning bidder has actively traded common stock and 60 other randomly selected unassisted acquisitions in which the bidder has actively traded stock	Event study. Analyzes abnormal returns of the acquiring firm, relative to the market, for different periods, with emphasis on two days—the announcement day and day before. In the case of the 19 failed-bank auctions, analysis focuses on stock returns of winning bidders. Analysis is based on stock market returns to the market and acquiring firms using a standard market model that accounts for risk. The model is estimated for 80 days to 11 days before announcement and 11 days to 80 days after. Also uses OLS to analyze differences in market reaction to assisted and unassisted mergers and the effect of the number of bidders and potential bidders on abnormal returns
James and Wier (1987b)	1972-83	60	Random sample of acquiring banks with actively traded stocks that are in the Compustat Banking and Finance File. Acquiring firms that made other acquisitions in the 6 months before acquisition are excluded	Event study. Analysis of abnormal returns on the stock, relative to the market, of acquiring banks covers the two-day and five-day periods up to the announcement date. Analysis of abnormal returns is based on a standard market model estimated over the period from 80 days to 15 days before announcement and 15 days to 80 days after. Also uses OLS to examine the effect, on returns to the acquirer, of the number of bidders, number of targets, and the ratio of size of acquired firm to the size of the target. Finally, examines relation between abnormal gains and attainment of concentration and market share
Neely (1987)	1979–85	26	Stock of acquiring and acquired banks is traded on NYSE, AMEX, or OTC. Acquirers are BHCs, and no regulatory mergers are included	Event study. Analyzes abnormal returns, relative to the market, for acquiring and acquired firms during the period from ten weeks before to 30 weeks after the acquisition announcement. Analysis is based on a standard market model estimated over the period from 119 weeks to 11 weeks before merger. S&P data are used to construct the market return index for banks. Attempts to distinguish between acquisitions of banks and of BHCs in terms of stock price effect

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquiring firms in FDIC-assisted and unassisted mergers have positive significant abnormal returnson the day before announcement and the day of announcement No pattern for returns to acquirers is apparent for the 50 days after merger The number of bidders has a significant negative relation with abnormal returns to acquirers For unassisted mergers (but not for assisted mergers), the number of potential bidders is negatively related, and the number of alternate targets is positively related, to abnormal returns to acquirers
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquiring firms have small but significant positive returns during the 2-day and 5-day periods up to the announcement date. Returns after announcement are not examined The number of targets is positively related to abnormal returns to acquirers, and the number of potential bidders is negatively related to acquirers' returns Returns to acquirers are positively related to ratio of target to bidder size Attainment of market share and concentration by acquirers are minimal, so achievement of market power is not an important source of observed gains
Wealth effects	Abnormal returns on stock	Residual analysis	Acquiring firms generally have normal returns Acquired firms have positive significant cumulative Abnormal returns before announcement and after

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Rose (1987a)	1970–85	106	106 merged banks plus 106 nonmerging banks that were matched, in terms of size and geographic market, with the merged banks. Wide variation insize and geographic location	Analyzes operating performance changes. Compares average performance of merging and nonmerging firms both before and after merger. Analysis covers the 1-year and 3-year periods before merger and various periods from one year to 8 years after merger. Acquiring and acquired firms are treated as a combined entity. Also reports findings of a survey of merging firms that asked respondents to specify motives for mergers
Rose (1987b)	1970–80	40 acquiring banks, 138 acquired banks	Acquiring banks are each paired with a nonmerging bank of similar size and location. Mergers have wide geographic representation. All acquirers are national banks. The acquired banks are independently selected in the same manner as the acquiring banks and are not necessarily acquired by the acquiring banks in the sample	Comparison of operating performance differences. All comparisons cover each of the five years before and after merger. Analyzes differences between merging and non-merging banks after merger. Also analyzes differences between merging and nonmerging banks in changes from pre- to post merger period
Trifts and Scanlon (1987)	1982–85	17 acquired and 14 acquiring	All cases involve interstate merger. Each acquiring and acquired bank has stock traded on NYSE, AMEX, or OTC. Sample includes both acquiring and acquired firms from 11 mergers and a total of 17 acquired banks and 14 acquiring banks	Event study. Analyzes abnormal returns on the stock price plus dividends, relative to the market, of acquiring and acquired firms for 40 weeks before announcement and 20 weeks after. Analysis is based on a standard market model estimated over the period from 61 weeks to 41 weeks before announcement and 21 weeks to 41 weeks after. Alternative market indexes of banks were used in the market models (S&P 500 and an index of bank stocks based on S&P data) and yielded the same results

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Performance changes	Return on assets Return on equity	Univariate *t* tests	Returns on assets and equity do not improve after merger when compared with those of non merging firms Returns on assets and equity of combined merging firms and non merging firms do not differ before merger Growth in assets and deposits do not improve after merger when compared with that of non-merging firms Market share of merged firms in local markets does not improve after merger when compared with that of non merging firms Growth in net earnings after tax does not improve after merger when compared with that of non-merging firms
Performance effects	Return on assets Return on equity Operating revenue/ operating expenses Revenues/employees Assets/employees	Paired comparison with *t* tests Multiple regression Canonical analysis	Operating efficiency (operating revenue/operating/expenses) of acquiring firms does not improve after merger when compared with that of non-merging firms Employee productivity (assets/employees) of acquiring firms does not improve after merger when compared with that of nonmerging firms Profitability of acquiring firms does not improve after merger when compared with that of non-merging firms Multiple mergers do not effect performance Acquired firms have lower rates of return than non merging firms before merger Acquired firms are more profitable than acquirers before merger Acquiring firms have lower operating efficiency and employee productivity than non mergering firms
Wealth effects	Abnormal returns on stock	Residual analysis	Acquiring firms have negative significant cumulative abnormal returns during the 20 weeks after announcement but no cumulative abnormal returns for the 40 weeks before announcement or for the entire 60-week period Acquired firms have positive cumulative abnormal returns for the 40 weeks before announcement and the entire 60-week period No abnormal returns to acquired firms for the 20 weeks after announcement Returns differ substantially among merger proposals Returns tend to be larger for merger proposals in which the size difference between acquiring and acquired firms is relatively small

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
de Cossio, Trifts, and Scanlon (1988)	1982–85	41 intrastate, 21 interstate	Stock of acquiring and acquired banks is traded on NYSE, AMEX, or OTC. Excludes banks making multiple mergers. 18 of 41 intrastate mergers include both bidder and target firms. 11 of 21 interstate mergers include both bidder and target firms	Event study. Analyzes the abnormal return on the stock, relative to the market, of acquiring and acquired firms for 30 weeks before announcement and 20 weeks after. Analysis is based on a standard market model estimated over the period from 50 weeks to 31 weeks before announcement and 21 weeks to 40 weeks after. Analyzes both inter- and intrastate announcements
Sushka and Bendeck (1988)	1972–85	41	Stock of acquiring banks is listed on NYSE or AMEX. Sample includes only acquiring firms	Event study. Analyzes abnormal returns on the stock of the acquiring firm relative to the market return. Calculation of abnormal returns is based on a mean-adjusted returns model and on a standard market model, and each yields the same results. The adjusted returns model is based on the period from 340 days to 120 days before Federal Reserve approval. The analysis Covers five days to 14 days before merger approval by the Federal Reserve and one day to 14 days after merger approval. Time period assessed seems to vary. Does not investigate effects on acquired firms. Analysis examines four types of merger: emergency, nonemer-gency, external, and internal
Baradwaj, Fraser, and Furtado (1990)	1980–87	23 hostile, 30 nonhostile	Acquiring or target bank is publicly traded. One-third of the hostile offers were successful. Hostile offers based on reports of unsolicited bids in the WSJ from 1980 to 1987. The 30 nonhostile mergers serve as a control group and were drawn from another study	Event study. Analyzes abnormal and cumulative abnormal returns of acquiring and acquired firms for various periods from five days before to five days after announcement. Compares abnormal returns for hostile bids with those for non-hostile bids. Analysis is based on a standard market model estimated for 150 days (from day 210 to day 61) before the announcement. Also compares characteristics of banks subject to hostile bid with those subject to nonhostile bid

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Wealth effects	Abnormal returns on stock	Residual analysis	Acquired firms experience positive significant abnormal returns over the entire period for both inter- and intrastate announcements Acquiring firms do not have abnormal returns over the entire period for either inter- or intrastate merger proposals Combining the dollar value of effects on acquiring and acquired firms shows net gains for intrastate merger proposals and no net gain or loss for interstate proposals Merger proposals involving large targets (relative to bidders) show greater gains than proposals involving relatively small targets
Wealth effects	Abnormal returns on stock	Prediction error analysis	Acquiring firms have negative significant abnormal returns in the 23 external merger proposals but generally normal returns for other kinds of proposals during the period surrounding Federal Reserve approval of a merger proposal Merger proposals involving banks internal to a BHC have no significant abnormal returns Merger proposals involving banks external to the BHC have negative significant abnormal returns
Wealth effects	Abnormal returns on stock	Residual analysis	Acquired firms have positive significant abnormal returns for various periods from five days before announcement to five days after Acquiring firms have negative significant abnormal returns during the period from five days before announcement to five days after Hostile bidders have a smaller negative return than nonhostile bidders Targets of hostile bids have significantly higher returns than targets of nonhostile bids Generally little difference in returns between successful and unsuccessful hostile bidders and between successful and unsuccessful hostile targets Estimates of net dollar value of wealth effects for bidders and targets combined indicate a positive significant net wealth effect from hostile takeover announcements and no significant net wealth effect from nonhostile announcements

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Bertin, Ghazanfari, and Torabzadeh (1989)	1982–87	33	Acquiring firms are all involved in an FDIC-assisted purchase and assumption of a failing bank. Analysis focuses only on acquiring firms. Stock of all firms is subject to continuous daily trading on an exchange	Event study. Analyzes abnormal returns on the stock of acquiring firms relative to the market. Analysis of abnormal returns covers 20 days before announcement to 20 days after, using stock price and dividend data from the WSJ. Also conducts OLS analysis of determinants of abnormal returns. Analysis is based on a standard market model estimated over the period from 121 days to 21 days before announcement
Dubofsky and Fraser (1989)	1973–83	101	Acquiring banks are selected on the basis of announcements appearing in the WSJ, and their stock must be actively traded (on an exchange or OTC) on the announcement date. Merger must involve a target bank that is at least one-tenth the size of the acquiring bank in terms of assets. Excludes combinations of equals	Event study. Analyzes abnormal returns on the stock of the acquiring firms during the two days covered by the announcement day and the day before announcement. Analysis is based on the market-adjusted returns method rather than a standard market model. Focuses only on acquiring firms. Focuses on different announcement effects before and after various dates. Also examines excess returns for various periods up to 50 days before announcement and 20 days after for mergers before and after the date (July 1, 1981) when two District Court decisions concluded that the Federal Reserve cannot apply stricter standards to mergers than does antitrust law. Conducts OLS tests to determine effects of several variables on abnormal returns
Hannan and Wolken (1989)	1982–87	69 targets, 43 bidders	Stock of acquiring and acquired firms is traded on NYSE, AMEX, or OTC, the announcement appeared in the WSJ, and the firms were not involved in a merger during preceding six months or the month after announcement. The 43 bidders are included only if they bid on one of the 69 target firms in the sample	Event study. Analyzes abnormal and cumulative abnormal returns, relative to the market, of the acquiring and acquired firms for up to 15 days before merger and 15 days after. Analysis is based on a standard market model estimated over the period from 90 days to 15 days before the announcement. Stock price data are from International Data Service's Daily Stock Price tape. The market return data are based on the Wiltshire Index

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquiring firms generally do not have significant abnormal or cumulative abnormal returns before merger or after There are a couple of significant positive returns during the four days before merger Higher outside board membership and location in a statewide branching state are associated with higher cumulative abnormal returns
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquiring firms have positive significant abnormal returns during the 2-day announcement period for announcements before July 1, 1981, and negative significant returns during the 2-day announcement period for announcements after July 1, 1981 Cumulative excess returns over the period from 50 days before announcement to 20 days after suggest some gain from announcement to acquirers before July 1, 1981, and some loss due to announcement after July 1, 1981 OLS tests show that no variables affect abnormal returns before July 1, 1981. After that date, a couple of variables affect returns, but they may not be conclusive
Wealth effects	Abnormal returns on stock	Residual analysis	Acquiring firms have negative significant cumulative abnormal returns both before announcement and after Acquired firms have positive significant cumulative abnormal returns both before announcement and after A calculation of the dollar value of the change in stock prices indicates no net change in value of he stock of the two firms combined Results generally do not differ significantly between large and small organizations for bidders or targets Net combined dollar value of wealth effects do not differ between inter- and intrastate acquisition proposals Net combined dollar value of wealth effects are significantly positive for acquisitions involving less capitalized targets and significantly negative for those involving more capitalized targets

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Kaen and Tehranian (1989)	1979–87	31in New Hampshire (8 bidders made all the proposals)	Mergers by banks in New Hampshire after a statewide branching law was passed in 1979. Announcement dates were determined primarily from the *Union Leader* newspaper. Excludes two mergers because other merger announcements were made within two days of the announcements of these two mergers. Stock returns for the eight bidders are based on data in the *Union Leader*, and the market return data are from the NASDAQ Bank Index	Event study. Analyzes abnormal returns on the stock of the acquiring firms during various periods from 10 days before announcement to 10 days after. Analysis is based on a standard market model estimated over the period from 136 days to 16 days before the announcement. Also analyzes returns for two different sub periods and uses OLS to analyze differences in returns due to method of payment and due to relative size of target and acquirer
Wall and Gup (1989)	1981–83	23	Acquiring banks are taken from those on the Automated Data Processing FASTOCK stock price file and with stock prices reported in the *American Banker*. Acquisitions are intrastate and involve BHCs, and acquired firm is at Least ten percent of the size of the acquirer	Event study. Analyzes abnormal returns on the stock, relative to the market, of acquiring firms for the period from two weeks before announcement to four weeks after. Analysis is based on a standard market model estimated over the period from 44 weeks to three weeks before announcement. Does not investigate effect on acquired firms. Additional tests seek to determine what variables influence the cumulative abnormal return
Hawawini and Swary (1990)	1971–86	123 (78 bidders, 123 targets)	Stock of acquiring and acquired banks is publicly traded, with stock price data on CRSP, OTC daily tapes, or the S&P Stock Price Record	Event study. Analyzes abnormal returns on the stock of acquiring and acquired banks during various periods from five weeks before, to five weeks after, the week of the announcement of a merger and other announcements. Analysis is based on a standard market model, as well as a mean-adjusted returns approach, estimated over the period from 57 weeks to sixweeks before the announcement week. Also analyzes abnormal returns due to announcement of regulator's decision and announcement of interstate legislation. OLS tests conducted to determine what factors explain abnormal returns
Rhoades (1990)	1981–87	68	Acquiring and acquired firms have more than $1 billion in assets. Covers 322 nonmerging firms with more than $1 billion in assets and located in same states as acquiring firms for pre-acquisition tests. Post acquisition tests include 13 acquired and 97 non-acquired firms	Analyzes operating performance changes. Compares performance of merging and nonmerging firms both before and after merger. Analysis is based on average performance over the period from three years before merger to three years after. Focuses on performance of the acquired firm and treats it as a separate entity from the acquirer both before and after merger

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquiring firms have a negative significant abnormal return on the day before announcement and a negative significant cumulative abnormal return on the announcement date and the day after The five mergers based on cash payment tend to show a positive return while the 26 mergers based on stock payment tend to show a negative return OLS tests confirm other findings and also show that a higher ratio of target size to acquirer size is associated with higher abnormal returns
Wealth effects	Abnormal returns on stock	Residual analysis	Acquiring firms generally have negative significant cumulative abnormal returns during four weeks after announcement
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquired firms have positive significant abnormal returns over the 11 weeks centered on the announcement week Acquiring firms have negative significant abnormal returns over the 11 weeks centered on the announcement week Crude estimates of net dollar value of wealth effects for bidders and targets combined indicate a possible small net increase in wealth for shareholders Intrastate merger proposals tend to have a more positive effect on wealth than interstate proposals
Efficiency and profit-ability effects	Return on assets Non-interest expenses/ assets	Logit analysis Multiple regression	Profit rates of acquired firms do not improve following merger when compared to those of non-acquired firms Non-interest cost efficiency does not improve relative to that of non-acquired firms Pre-acquisition profitability and efficiency of acquired firms are no different than for non-acquired firms

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Allen and Cebenoyan (1991)	1979–86	138	Only acquiring firms; they are BHCs with stock listed on NYSE or AMEX and stock prices on CRSP.	Event study. Analyzes abnormal returns on the stock of the acquiring firm relative to the market. Analysis covers 11 days, apparently before the merger announcement. Abnormal returns are calculated using a standard market model estimated over the period from 136 days to 16 days before the announcement. Analyzes various differences, including stock price reaction to mergers, between four sets of firms with different degrees of management ownership and concentration of stock ownership. Emphasis is on differences in stock returns due to the degree of management owner-ship and concentration of stock ownership
Cornett and De (1991)	1982–86	37 targets involving 152 bids by 59 bidders	Includes only interstate mergers. Acquiring or acquired bank must be traded on a major exchange or over the counter. 36 of the 37 merger proposals occurred. Acquiring banks were excluded if a second acquisition was made within 15 days of initial bid. Acquiring banks, or bidders, did not necessarily bid on any of the 37 target banks in the sample	Event study. Analyzes abnormal returns of bidding and target banks for two days—the announcement date and the day before, with data presented for 15 days before and 15 days after announcement. Analysis is based on a standard market model estimated over the period from 16 days to 75 days *after* the announcement event and relies on CRSP data. Also analyzes announcement effect of state legislation allowing entry by out-of-state banks and uses OLS to analyze the effect of the number of potential bidders on abnormal returns around merger announcement
Spindt and Tarhan (1991)	1986	297 (61 intra-BHC, 236 newly acquired)	Broad sample of mergers includes intra-BHC and newly acquired firms. A control group of matched nonmerging firms (similar in size and state) is used to account for industry trends	Analyzes operating performance changes. Analysis is based on the performance of firms in each of the two years before and after merger. Analysis treats acquiring firms as separate entities before merger and as a combined entity with the successor after merger. Differences in performance between the merging and nonmerging firms are the basis for analysis. Also com-pares performance of mergers (of affiliates) internal to the BHC with mergers of banks not previously owned

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Wealth effects	Abnormal returns on stock	Residual analysis	Acquiring firms do not have abnormal returns during the 11 days before announcement Firms with both higher management ownership and concentration of stock ownership have higher cumulative abnormal returns than firms that were lower in either category
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquiring and target firms have positive significant returns on the day of announcement but generally negative returns for the next 15 days The negative returns to the bidder during 15 days after announcement negate the gains on announcement day, although the cumulative abnormal return to the targets remain positive over the 15 days in spite of negative abnormal returns after announcement Acquiring banks are not affected by legislation allowing out-of-state entry, but acquired banks have a positive return on announcement day The existence of more potential bidders does not reduce returns to acquirers
Performance effects	Net income/equity Net income/assets Employee expenses/ revenue	Univariate sign tests	Before merger, externally merged firms generally exhibit poorer performance in terms of rates of return and the ratio of employee expenses to assets than successor firms. Internally merged firms show no difference in performance when compared with the successor firms Return on assets of newly acquired (external) firms generally does not improve after merger Return on equity of newly acquired (external) firms generally tends to improve after merger Ratio of employee expenses to assets of newly acquired (external) firms generally does not improve after merger Internally merged firms generally do not show performance improvements after merger

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Baradwaj, Dubofsky, and Fraser (1992)	1981–87	108	Stock of acquiring firms is listed on CRSP daily file or CRSP NASDAQ historical file. The target firm is at least ten percent of the size of the acquirer. Analysis focuses only on the acquiring firm	Event study. Analyzes abnormal returns to the stock of the acquiring firm relative to the market as measured by a CRSP value-weighted portfolio. Abnormal returns are calculated on the basis of a standard market model estimated for the period from 60 days to 11 days before announcement and 11 days to 60 days after. Analysis covers various periods From five days before to five days after the announcement. Compares abnormal returns of inter- and intrastate mergers. Also compares stock effects of merger announcement before and after the June 10, 1985, Supreme Court decision validating constitutionality of state laws permitting interstate banking
Berger and Humphrey (1992)	1981–89	57 (involves 69 mergers, but multiple mergers in the same or contiguous years are combined)	Acquiring and acquired firms have more than $1 billion in assets. Includes all nonmerging firms in U.S. with more than $1 billion in assets, for an average sample size of about 300 banks	Analyzes operating performance changes. Analysis compares performance rank from before merger to after. Acquiring and acquired firms are treated as a combined entity before merger and after. A translog total cost function is estimated for each year (1980–90) for merging and nonmerging banks, and each bank's cost function residual over time is compared with the average residuals for each of the members of the peer group (large merging and nonmerging firms). The residual, which represents X-efficiency performance, and other performance measures are used to rank merging firms relative to their peers before and after merger. Pre- and post merger performance is measured over varying time periods. Controls for deposit overlap and difference in performance between acquiring and acquired firms before merger

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Wealth effects	Abnormal returns on stock	Residual analysis Multiple regression	Acquiring firms have negative significant abnormal returns five days before announcement and five days after for both inter- and intrastate mergers Negative abnormal returns to inter- and intrastate acquirers exist before and after the June 10, 1985, court decision on state interstate banking laws
Efficiency and profit-ability effects	X-efficiency rank Total efficiency rank Return on assets Average total costs/ assets Non-interest expenses/ assets	Multiple regression	Cost efficiency, on average, does not improve following merger Some mergers improve efficiency and some worsen efficiency Profit rates, on average, do not improve following merger Some mergers improve profit rates and others worsen profit rates Firms making in-market mergers do not have efficiency improvements when compared with other mergers or firms Mergers in which the acquiring firms are more efficient than the acquired do not lead to efficiency improvements when compared with other mergers or firms

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Cornett and Tehranian (1992)	1982–87	30	Acquiring and acquired firms are publicly traded with stock return data from CRSP tapes and Moody's Bank Manuals. Also includes, as a proxy for the industry, all banks with stock traded on the NYSE or AMEX (30 to 36 banks, depending upon year)	Uses both the event study and operating performance methodologies. Event study analyzes stock prices for the day before and the day of announcement using a standard market model estimated over the period from 136 days to 16 days before announcement. Analysis of operating performance covers three years before and three years after merger. Also compares performance and abnormal returns of inter- and intrastate mergers. Operating performance of combined acquirer and acquired is compared to the mean performance of all banks with stock traded on the NYSE or AMEX
Linder and Crane (1993)	1982–87	47 (25 intra-BHC, 22 newly acquired)	Acquiring and acquired banks are located in New England states. A control group of all nonmerging banks in the same state is used to account for industry trends. On average, the acquired firm is 35 percent as large as the acquirer, although this is not clear in the data. Includes intra-BHC mergers as well as newly acquired firms	Analyzes operating performance changes. Analysis is based on the performance of firms during one year before merger and one year and two years after, as well as changes over the period. Performance of merging firms is compared with that of a comparable industry group. Analysis treats acquiring and acquired firms as a single entity both before merger and after. Efforts are made to adjust data for mergers occurring after the merger under analysis. Compares findings between newly acquired banks and intra-BHC mergers
O'Keefe (1992)	1984–90	469 (123 assisted, 346 non-assisted)	Covers acquiring banks that made FDIC-assisted acquisitions and the acquired bank was absorbed into the acquirer. A group of non-assisted acquirers is included for comparison. Acquiring firms are generally small. The majority of these mergers involve firms in the same market. Acquisitions are excluded if another acquisition by the acquirer is made within a period of three years before cquisition or after	Analyzes performance changes from the two years before merger to the two years after. Emphasis is on comparison of assisted with unassisted mergers. Only non-interest expenses to assets are compared with an industry control group. Acquiring and acquired firms are treated as a combined entity after acquisition

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Performance and wealth effects	Abnormal returns on stock Expenses/revenues Cash flow/market value of assets Return on equity Return on assets	Various univariate tests Residual analysis	Efficiency overall (total expenses/revenues) does not improve relative to that of the industry, although employee productivity improves Ratio of cash flow to market value of assets improves relative to that of the industry Return on equity improves relative to that of the industry Return on assets does not improve relative to that of the industry Acquiring firms have negative abnormal returns in the two days covered by the announcement day and the day before Acquired firms have positive abnormal returns in the two days covered by the announcement day and the day before, and the combined firm has positive aggregate returns Inter- and intrastate mergers experience similar abnormal returns
Performance effects	Operating income (and components of operating income)/ assets Noninterest expenses/ assets Growth in income and assets	Univariate *t* tests Multiple regression	Operating income/assets and growth in operating income of merging banks, as a group, do not improve after merger relative to those of non-merging firms Cost efficiency (non-interest) of merging banks, as a whole, declines relative to that of nonmerging firms Intra-BHC mergers generally have greater performance improvement, in terms of operating inome/assets and growth in operating inome, than newly acquired (not de novo) firms Operating income/assets of intra-BHC mergers improves relative to that of nonmerging firms Cost efficiency (non-interest) and growth of intra-BHC mergers decline relative to those of nonmerging firms Growth in assets of merging firms, as a group, is slower than that of nonmerging firms
Performance effects	Non-interest expenses/ assets Interest expenses/ assets Return on assets Return on equity	Graphical trend analysis	Efficiency for the assisted and unassisted merged firms, in terms of both interest and noninterest expenses to assets, does not change, a result similar to industry trends in noninterest expenses Assisted and unassisted mergers generally yield similar results No efficiency changes for those merged firms operating in the same county before merger Return on assets for the assisted and unassisted merged firm does not change Return on equity for the assisted and unassisted merged firm does not change

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Rose (1992)	1980–89	279	Limited to interstate acquisitions. A control group of banks apparently not involved in an interstate acquisition, of similar size and located in the same county or metropolitan statistical area as the acquired bank, is included for comparison. The sample should have a rather wide variation in geographic location and size of institution	Analyzes operating performance changes. Studies performance of acquired and acquiring banks both before acquisition and after. Analysis usually covers each of five years before acquisition and after. Performance of acquiring banks is analyzed separately. However, for some analyses all acquired banks owned by the same BHC are consolidated as a single entity and comparable hypothetical sets of peer banks are constructed for comparison. The detailed tabular comparisons of performance before merger with performance after, by year, do not appear to account for peers, so findings may be difficult to interpret. A multiple regression model that analyzes a smaller number of performance measures does control for performance of peers
Spong and Shoenhair (1992)	1985–87	179	Limited to interstate acquisitions, a selection that should involve fairly large firms operating in different geographic areas. Also includes a control group of banks not under interstate ownership that are similar in terms of size and location	Analyzes observed performance changes. Analysis is based on data for one year before merger and one year to three years after. Only the acquired firms are studied. A peer group is used for comparison to control for industry trends. Analysis is based on comparisons of means and medians of the acquired firms with the control group for various performance measures
Srinivasan and Wall (1992)	1982–86	240	Acquiring and acquired firms each have more than $100 million in assets. An industry wide sample of nonmerging firms is used to control for industry trends in univariate tests but not in multiple regressions, where time dummy variables are used instead. On average, the acquired firm is 32 percent as large as the acquirer	Analyzes operating efficiency and dollar value of expense changes. Analysis is based on average efficiency and expenses for the two years before merger and one year to four years after merger. The analysis treats the acquiring and acquired firms as a single entity both before merger and after. The analysis accounts for the degree of overlap of deposits in local markets. Multiple acquisitions in one year by a firm are treated as a single merger. 20 outliers, in terms of expense ratios, are excluded
Srinivasan (1992)	1982–86	Two samples: 77 in south-east, 240 in entire U.S	Acquiring and acquired banks have more than $100 million in assets. Nonmerging banks are also included	Analyzes operating efficiency changes. Focuses on efficiency changes from two years before merger to each of four years after merger. Acquiring and acquired firms are treated as a combined entity before merger and after. Changes in efficiency of merged banks are compared with nonmerging banks. Accounts for degree of market overlap of merger partners

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Efficiency and profit-ability effects	Operating expenses/ total revenue Noninterest operating expenses/total expenses Noninterest expenses per employee Return on assets Return on equity	Multiple regression	Multiple regression results, which include a control group of banks, indicate the following: Changes in operating efficiency (operating expenses/ total revenue), return on equity, and market share for various types of loans and deposits do not differ from those of nonmerging firms Tabular results suggest that return on equity of merging firms, but not return on assets or efficiency, improves somewhat relative to that of a control group
Performance effects	Return on assets Return on equity Overhead costs/assets Personnel expenses/ assets	Tabular comparisons	Cost efficiency (overhead) tends to improve somewhat relative to that of peers Returns on assets and equity generally decline relative to those of peers based on mean and do not decline or increase relative to those of peers based on median
Efficiency effects	Noninterest expenses/ total assets Noninterest expenses in terms of dollar volume	Wilcoxian signed rank tests Multiple regression Univariate *t* tests	Cost efficiency does not improve relative to that of nonmerging firms Greater office overlap tends to be associated with lower costs after merger but apparently not with efficiency gains
Efficiency effects	Noninterest expenses/ operating income Also analyzes components of noninterest expenses, i.e., salaries, premises, and other expenses	Univariate *t* tests Multiple regression	Efficiency of merged firms does not improve relative to that of nonmerging firms Changes in efficiency of firms making in-market mergers do not differ from those of firms in other mergers Firms in mergers of equals tend to have efficiency gains when compared with firms in other mergers Overall efficiency findings are similar for banks in southeast and U.S. as a whole

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Crane and Linder (1993)	1991	1	Fleet–Bank of New England merger	Case study analyzing operating performance changes. The study examines the firm's projections for cost cutting (both real reductions and financial reductions) and uses publicly available data to analyze performance before merger and after. Examines expenses for one year after merger. Analysis is based on the combined banks in the BHCs rather than the BHC. Changes are not compared with a control group
DeYoung (1993)	1987–88	348	348 mergers approved by the Comptroller of the Currency and covering a wide range of bank sizes. About 31 percent of mergers involve purchase and assumptions of failed banks and 43 percent involve banks already affiliated within the same BHC. Sample includes all other commercial banks for comparison	Analyzes operating changes in efficiency. Compares pre- and post merger costs of merging banks to efficiency benchmarks estimated from a ‘‘ thick’’ cost frontier that was estimated for all U.S. commercial banks using a multiproduct translog production function. Cost efficiency is measured for one year before merger and the fourth year after merger. Efficiency is assessed in terms of total expenses to total assets. Analyzes (1) pre-merger cost efficiency by comparing costs of the target and acquirer, separately, with the pre-merger thick frontier benchmark and (2) the post merger efficiency of the merged firm with the post merger benchmark. Also compares the post merger position of the merged firm relative to the post merger benchmark with the pre-merger position of the acquirer relative to the pre-merger bench-mark to determine whether efficiency improved
Peristiani (1993a)	1981–88	Two samples, large number in each	One sample, for tabular analysis, and one, for statistical analysis, covering all banks involved in multiple mergers. Includes about 2,000 mergers and a control group of nonmerging banks	Analyzes operating performance changes. Examines performance during one year before merger and two years to four years after. Compares performance of internal BHC mergers, intrastate mergers, and FDIC-assisted mergers. Also separately examines mergers before 1986 and the top 200 mergers based on target size. Analysis focuses on the target and acquirer separately before merger and on the survivor after merger

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Efficiency effects	Noninterest expenses	None	Noninterest expenses declined about as projected—30 percent over the year following merger, compared with a ten percent decline in assets No data reported on total expense results The acquiring bank was more efficient than the acquired at the time of merger
Efficiency effects	Improvement in X-efficiency rank based on total costs/total assets	Univariate *t* tests Multiple regression	Efficiency gains do not generally result from merger Efficiency gains are most likely when both the target and acquirer are inefficient before merger rather than when the acquirer is more efficient than the target Acquiring banks, on average, are somewhat more efficient than targets Both acquiring and target firms exhibit substantial inefficiency relative to ‘‘ best-practice’’ firms
Efficiency and profit-ability effects	Net income/total assets Noninterest expense ratio. Denominator not clear but probably assets	Univariate *t* tests	Efficiency does not improve in internal BHC mergers nor for all mergers when compared with that of a control group of nonmerging banks In-market mergers produce no improvement Profit rates for overall sample do not change significantly relative to those of a control group Results vary somewhat over different groups compared, but overall findings hold

Study	Year Studied	Number of mergers or announcements[1]	Characteristics of sample	Methodology[2]
Peristiani (1993b)	1981–88	4,900 (2,000 intra-BHC mergers, 2,900 external mergers)	All bank mergers, including about 1,000 FDIC-assisted mergers. Multiple mergers by a bank in 1 year are treated as single merger. Includes a control group of nonmerging banks of similar size and in the same states as merging banks	Analyzes operating performance changes in terms of expense/income ratio and efficiency. Compares changes in profit rates and expense ratios from one year before merger to the average of the four years after for merged firms and a control group. Also estimates a multiple product translog cost function to derive measures of scale and X-efficiency. Compares changes in scale and X-efficiency from one year before merger to the average of two to four years after for merged firms and a control group. Distinguishes between intra-BHC, intrastate, and FDIC-assisted mergers. Focuses primarily on the combined entity before merger and after. Also uses OLS to analyze determinants of mergers including a deposit overlap variable
Rhoades (1993)	1981–86	898	Includes banks or BHCs engaged in horizontal, or in-market, mergers. Also includes about 10,000 nonmerging banks	Analyzes operating performance changes. Two methodologies are used. One analyzes changes in expense ratios from the three years before merger to the 4th through 6th years after. The other analyzes changes in efficiency quartile from the three years before merger to the fourth through sixth years after. In acquisitions by BHCs, the tests compare efficiency of the combined entity (before merger and after) with nonmerging firms. The tests account for the degree of office overlap and are conducted for each of the years 1981–86

Hypothesis or issue addressed	Performance measures [3]	Type of test [4]	Findings
Efficiency and profit-ability effects	Return on assets Noninterest expense ratio. Denominator not clear but probably assets Change in scale efficiency Change in X-efficiency	Univariate *t* tests Multiple regression	Noninterest expense ratios do not improve relative to those of a control group for firms in multiple mergers. Expense ratios of firms in single mergers increase relative to those of the control group Return on assets of the combined merged firm improves, from a low pre-merger level, relative to that of the control group, although the return on assets for the acquirer alone declines X-efficiency does not improve, and may even decline, relative to that of the control group Scale efficiency improves for firms in multiple mergers, and declines for firms in single mergers, relative to that of the control group Branch, or deposit, overlap between the acquiring and acquired firms is not related to changes in efficiency or profitability
Efficiency effects	Total expenses/assets Noninterest expenses/ assets	Multiple regression Logit analysis	Ratio of total expenses to assets does not change for firms doing in-market mergers when compared with that of nonmerging firms Ratio of noninterest expenses to assets does not change for firms doing in-market mergers when compared with that of nonmerging firms A greater degree of office overlap of merging firms is not associated with an improvement in efficiency relative to that of nonmerging firms Acquiring banks are, on average, more efficient than acquired banks

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Name Jabsheh, Faten Yousef

Education

May, 1994 Ph.D., Doctorate Degree in Political Economy,
Boston University, Boston, Massachusetts, U.S.A.

May, 1998 M.B.A., Masters Degree in Business Administration,
Roosevelt University, Chicago, Illinois, U.S.A
- Areas of Concentration: Economics and Marketing.

May, 1990 M.S., Masters Degree in International Relations,
Boston University, Boston, Massachusetts, U.S.A
- Areas of Concentration: Privatization and Public Sector Management.

December, 1988 B.S., Bachelor Degree in Political Science,
University of Rhode Island, Kingston, Rhode Island, U.S.A
- Areas of Concentration: Public Policy and Comparative Methods.

Professional Experience

December 2000 – present:

Kuwait Institute For Scientific Research (KISR)
Techno-Economics Division,
Quantitative Methods and Modeling Department
Research Associate

The primary focus is on developing proposals for contract research, pertinent to the macro and micro issues of the various sectors of the Kuwaiti economy with the objective of devising mechanisms to increase value-added and competitiveness in vital sectors and propose restructuring scenarios for others. Areas of activity include the banking sector, the petroleum sector, privatization, public sector management, feasibility studies and project evaluations. Most recent research activities include banking mergers and acquisitions, financial liberalization and Islamic banking and investment.

May 1999 – May 2000:

KCC, Kuwait Catalyst Company, Kuwait
Senior Market Analyst

Prepared the Business Plan and the Marketing Plan for this Petrochemical company for 1999, 2000 and 2001. This included combining and coordinating the Operational plans for the six functional units at KCC; corporate, finance, production, construction, information systems and marketing, to produce a comprehensive, effective and operational document for the company. The Marketing Plan prepared is a more focused, research-intensive effort that includes all the facets of marketing that are applicable to the products and the geographical markets involved. Issues covered range from market intelligence to exploring and devising market niches.

May 1996 – December 1998

American Interpreters Consultants, Chicago, Illinois,U.S.A
Interpreter

Interpreted and translated legal, business and civil cases and secrecy agreements in court, and out of court, in situations of plea-bargaining.

January 1996 – December 1997

Comprehensive Planning for Small Ventures, Chicago, Illinois, U.S.A
Marketing Consultant

Prepared comprehensive business plans for small businesses seeking financing in Illinois and the Mid-Western region, at large. Ventures ranged from $50,000 bookshops to $40,000 manufacturing enterprises.

September 1992 – May 1994

World Bank, Washington, District of Columbia, U.S.A
Consultant (outsource)
Worked with the Middle East & North African (MENA) regional development program on selected research topics in the fields of privatization and public sector management.

Summer 1988

Department of the Attorney General, State of Rhode Island and Providence Plantations, Rhode Island, U.S.A
Legal Aid, Civil Department
Worked with a team of lawyers, financiers and accountants that were responsible for researching three key banking projects related to the New England Savings and Loans crisis and its legal and economic ramifications in the state. Researched numerous civil cases, formulated legal briefs and memoranda and regularly attended court hearings related to these cases.

January 1987 – December 1988

University of Rhode Island, Rhode Island, U.S.A
Department of Political Science
Teaching Fellow
Taught three lecture-style courses: 'Major Political Ideologies,' 'Introduction to Political Economy' and 'Comparative International Relations.' Post requirements included giving weekly lectures, formulating and evaluating examinations for 150 students, in addition to organizing seven major presentations by key guest speakers in the United States in various fields.

Publications

- Akashah, Saad and Jabsheh, Faten. OAPEC Journal. "Diversification of the Kuwaiti Economy". Kuwait: 2000.
- Akashah, Saad and Jabsheh, Faten. ALESCO Conference publication, "Funding Higher Education in the Arab World." Tunisia: Nov. 2000.
- Jabsheh, Faten. Industrial Bank of Kuwait (IBK) Economic Series. "Impact of the GATS on the Kuwaiti Banking Sector and Ways to Achieve Greater Competitiveness." (Series No. 65) Kuwait: June, 2001.
- Akashah, Saad, Jabsheh, Faten, and Behbehani, Weam. ALESCO, Scientific R&D Program. "Financing Research and Development Through SMEs (Small and Medium-Sized Enterprises)." March, 2002.
- المنظمة العربية للتربية والثقافة والعلوم– إدارة برامج العلوم والبحث العلمي- الاجتماع العربي الموسع بشأن الدراسة التحليلية لاستراتيجية العلوم والثقـــافة في الوطن العربي– تمويل البحث والتطوير من أجل التنمية العربية: الحلقات الضائعة. دولة الامارات العربية المتحدة – الشارقة.
- Jabsheh, Faten. Science and Technology Journal. "Future Economic Challenges." Kuwait; August-September 2002. (Series No. 98).
- Jabsheh, Faten. Journal of Finance & Industry. "Why Do Banks Merge: Typology of the Causes and Effects of Merging." December 2003 (Issue No.21)

Technical Reports

- Evaluation and Performance Measures for the Outputs of Research and Development at the Kuwait Institute for Scientific Research. Kuwait Institute for Scientific Research, (KISR), August 2002.
- The Viability of Increasing Efficiency and Competitiveness in Banking through Mergers and Acquisitions. Kuwait Institute for Scientific Research, (KISR), October 2003.
- Financial Liberalization and Prospects of Mergers and Consolidations in the Kuwaiti Banking Sector. Kuwait Institute for Scientific Research, (KISR), February 2004.

Restricted Researches

- The Impact of Financial Liberalization on the Regional and Local Islamic Banking Industry. 2004 (Project Leader)
- Millennium Challenges and Merging in the Kuwaiti Banking Sector. 2003 (Project Leader)
- The Role of Commercial Banks and Private Housing in the State of Kuwait. 2002 (Task Leader)

Feasibility Studies

- Direct Upgrading Process for Heavy Crude Oil – a Joint Venture between KISR and Idemitsu Kosan (JCCP – Japan). (2000 - 2004)
- Commercialization of a Locally Customized Bioinsecticide. (2003)
- Establishment of a Bottled Drinking Water Company. (2003)
- Establishment of a New Central Food Control Laboratory for the State of Kuwait. (2004)

Training

- Training Course at the Kuwait institute for Scientific Research, (KISR)
  Course Title: Economic Assessment of Projects: An Introduction.
- Training Course at the Kuwait institute for Scientific Research, (KISR)
  Course Title: R&D Management.

Conferences

June 2003	Presented a paper entitled, "An Analysis of the Kuwaiti Banking Sector; Its Performance, Prospects and Challenges, at the 2nd European Conference of the Middle East Economic Association (EEA), at the University of Versailles, Versailles, France.
January 2003	Attended the GDN, Global Development Network Conference, entitled, "Globalization and Equity", Cairo, Egypt.
October 2002	Attended the "Investment Funds Conference; Experiences and Ambitions," Kuwait.
January 2002	Presented a research paper entitled, "The GATS Agreement and Liberalizing the Kuwaiti Banking Sector," at the Economic Research Forum (ERF), Cairo, Egypt. (ERF invitation and funding)
November 2001	Presented a research paper entitled, "Impact of the GATS on the Kuwaiti Banking Sector and Ways to Achieve Greater Competitiveness," at The 3rd International Conference on "Money, Investment and Risk" at Nottingham Trent University, Nottingham, U.K, (A KFAS Funded Mission).
May, 2001	Attended the First Conference for Islamic Financial Institutions, Kuwait.

November, 1999	Attended UNIDO, United Nations International Development Organization, “Regional Development” Conference, Cairo, Egypt.

Workshops & Seminars

October 2003	In-House Training Course at the Kuwait Institute for Scientific Research (KISR), Risk Assessment and Analysis. Kuwait:
October 2001	Feasibility Study: Revision and Preparation Course, Projacs, Project Analysis and Control Systems Co., Kuwait.
April 2001	Symposium: "Managing the Industrial Environment." The National Company for Environmental Services. Kuwait.
March 2001	UNESCO Program for the Training on Management of Scientific Research and Transfer of Technology, (STEMARN) Workshop: “Project/Resource Capacity Management in Contract R&D.” Kuwait.

Professional Memberships

- Kuwait Economic Society
- Golden Key National Honors Society
- American Women’s Business Association
- National Political Science Honors Society (Pi Sigma Alpha)

Honors

- Graduated with high honors, University of Rhode Island, 1988.
- Selected for membership of the U.R.I Honors Board & Program, 1987-1988.

Kuwait Foundation for the Advancement of Sciences (KFAS), a private non-profit organization, oriented towards public service, was instituted by an Amiri Decree, issued in 1976. KFAS is managed by a Board of Directors, chaired by His Highness, the Amir of the State of Kuwait. Major finances are received from Kuwaiti shareholding companies. The broad mission of KFAS is focused on human and cultural development through a set of scientific programs aimed at nurturing basic and applied research, sponsoring workshops and conferences, promoting cultural awareness, publishing books, encyclopedias and journals, awarding prizes to meritorious scientists, contributing to the development of the national scientific infrastructure and establishing centers of excellence in the State of Kuwait.

مؤسسة الكويت للتقدم العلمي

"مؤسسة خاصة ذات نفع عام" أنشأت بموجب مرسوم أميري صدر في عام ١٩٧٦ وبدعم مادي من الشركات المساهمة الكويتية. يدير المؤسسة مجلس إدارة يرأسه حضرة صاحب السمو أمير البلاد "حفظه الله" ويضم ستة أعضاء تختارهم الشركات المساهمة الكويتية لمدة ثلاث سنوات. رسالة المؤسسة تنصب في مجالات التنمية البشرية والحضارية عبر برامج وأنشطة علمية لدعم الأبحاث والمؤتمرات والتدريب والنشر والثقافة العلمية، ولتطوير البنى التحتية في المؤسسات التعليمية والبحثية، ولإنشاء مراكز علمية متقدمة.